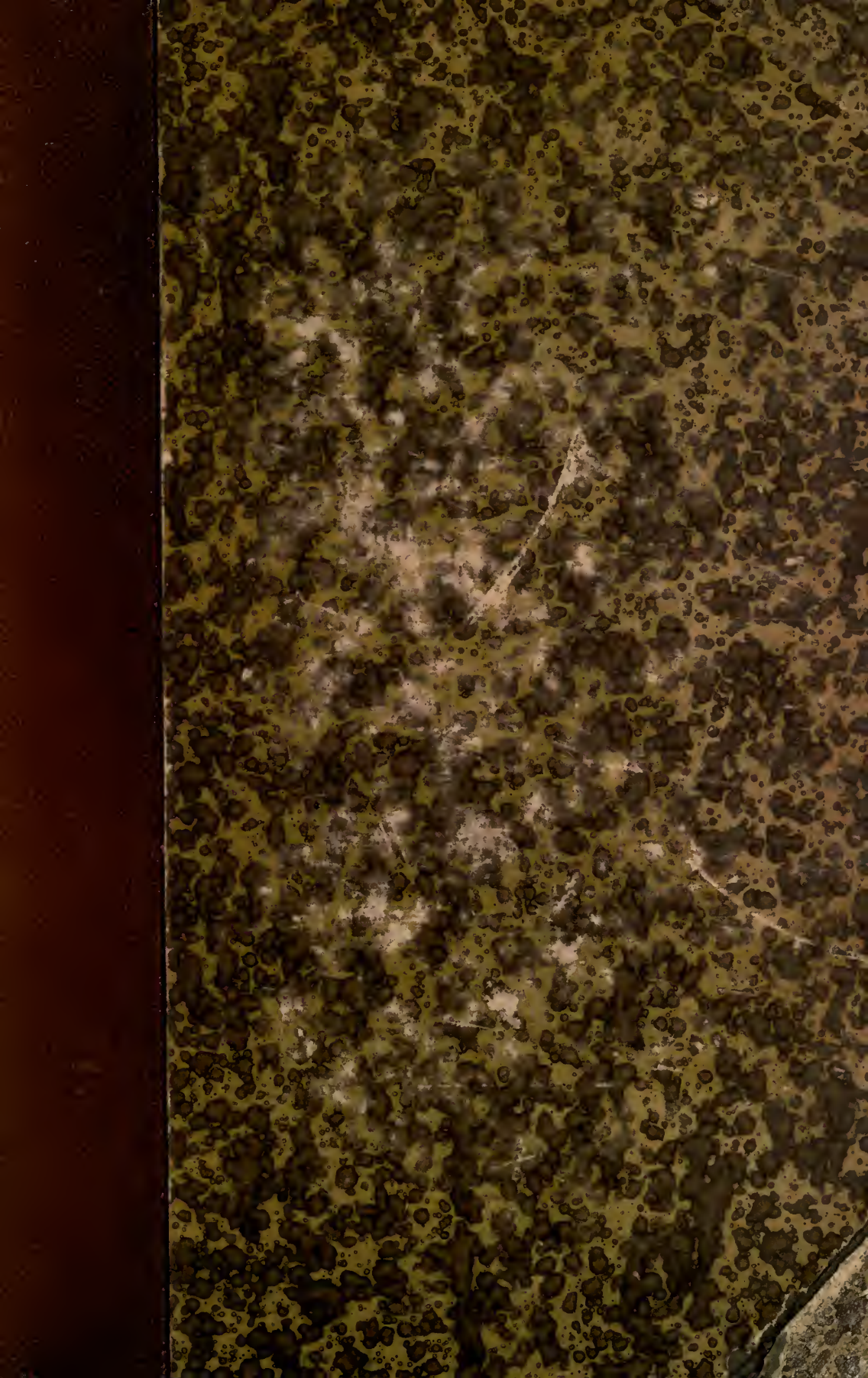

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Legislative Regulation of Railway Finance in England

CHING CHUN WANG

PREFACE

The purpose of this study is to find out what rules the English Parliament has adopted from time to time for the regulation of railway finance, and to ascertain, as far as possible, why these rules were adopted, how they have been applied, and to what results they have led.

In this study, the writer used the series of the so-called finance acts as the back bone. After having become familiar with the provisions in these finance acts and having classified these numerous provisions into a number of divisions, he then traced, as far as he could, the parliamentary debates upon these measures. He also endeavored to compare the original bills with the amended ones as well as to examine other contemporary bills which had anything to do with these finance bills, with the hope of understanding the position of the legislators. The writer also took care to examine the popular, the railway, as well as the expert financial writers' opinions prevailing during those years when these regulative measures were adopted or agitated. For this purpose the London Times, the Railway Times, and the Economist were most frequently consulted.

In the following pages, the writer has endeavored first of all to trace the development of the general legislation on railway finance so that a fairly comprehensive idea of the nature of legislative regulation may be gained. Then follows a review of the efforts of parliament to secure proper restriction upon the issue of capital securities, attention being given, in the first place, to share capital. Although loan capital forms only about one-third of the total railway capital, the method of control has loomed large in the English system of regulation. Accordingly the questions of limitation upon the borrowing powers of the railway companies, the registration of railway securities, as well as the regulation of loan capital itself have been treated in some detail. The attitude of Parliament toward railway stock watering is also shown. To the important features of control of accounts, government audit, and inspection two chapters are devoted.

Most of the information contained in this study is obtained from such original sources as the British Statutes at Large, reports of parliamentary and departmental committees, parliamentary debates, direct communications from offices of the Board of Trade, and similar material.

CONTENTS

CHAPTER I

GENERAL LEGISLATION ON RAILWAY FINANCE

As England was the pioneer of railway building so was she the first to make experiments in the regulation of railway finance. English statesmen had recognized the importance of regulating railway finance before any other country had seriously considered the question. As early as the railway itself was introduced, we find traces of efforts which were made by the English Parliament in this direction.

One thing which especially stands out to the credit of the English legislature is the fact that it had learned a great deal about the regulation of railways during the first fifty years of railway enterprise and had then arrived at certain important conclusions which, in some other countries, have not been properly understood until very recently. From the early thirties, English legislators have recognized that the interest of the railways is bound up with that of the public and that the interests of the two cannot be separated.[1] Herein lies a partial explanation of the fact that Parliament practically has never enacted laws which might properly be called hostile to the railway companies.

The English railways, like those of the United States, are private enterprises, and under private operation. The part played by both Governments is that of a supervisory nature. The Governments of both countries have thought of purchasing and owning their railways,[2] and both have refrained from adopting that course.

The systems of regulation of the two countries are also similar.

[1] See the remarks of Mr. Homes in the House of Commons, 1836. Hansard's *Parliamentary Debates*, series 3 (hereafter called Hansard), v. 46, p. 1336.

[2] Detailed provisions were made in the Railway Regulation Act, 1844 (7 & 8 V. c. 85), for Government purchase of railways under certain conditions.

The early railway charters in the United States "reveal almost at a glance," says Prof. B. H. Meyer,[3] "their common origin in the English law." The principles underlying our federal laws, as well, bear much resemblance to those accepted in England. But in spite of such great similarities there is a striking difference between the two systems of regulation. This difference, however, lies not so much in the regulations themselves as in the manner and emphasis of regulation. First of all, the United States has never attempted any strict regulation of railway finance, while England has always regarded the regulation of this branch of railway enterprise as essential. Then again in England there is only one kind of regulation — namely, that adopted and enforced by the national legislature, while in America the numerous systems of state regulation have been of greater importance or at least have given the railways more trouble than the federal regulation, though recent developments indicate a large increase of the importance of the latter. The railways in England, therefore, do not have any such complicated controversies as have resulted in the United States from the conflicting regulations of the state and federal governments.

England also has enjoyed from the beginning many advantages, which other countries envy. There has always been a class of enterprising capitalists ready to embark in railway undertakings and a class of men qualified by ability and business habits for the duties of railway directors, officers, and engineers. Therefore, instead of having trouble in persuading capital to embark in railways when the enterprise was first introduced, as was generally the case in other countries, England found it necessary to caution capitalists from investing too readily. Her problem in the beginning was not to induce investors to come forward, but to caution them to be steady and to protect them from being swindled by "bubble" schemes. Her difficulty has not been to extend her railway system but to prevent superfluous construction.

The English railway system had its origin in the enterprise of individuals interested in the different localities. The efforts were not fostered by the legislature as objects of national concern, as was often the case on the continent, but were regarded

[3] *Annals of American Academy of Pol. and Social Science*, vol. 10, p. 390.

as projects undertaken for the profit of their promoters, which Parliament might sanction for public advantage. In dealing with these undertakings the legislature followed the policy which had been pursued with success and benefit to the country since the middle of the eighteenth century, of allowing private enterprise to develop and manage inland navigation. Under this system each project was considered entirely on its own merits, and sanctioned by a private act of Parliament which contained the entire statute law applicable to the undertaking.[4]

In the regulation of railway finance, as in other branches of government activity, each country has adopted a policy deemed at the time to be most suitable to its own special requirements. "The continental system is a paternal system in which the government overlooks and controls all the acts of the companies. The American system is one of complete freedom. Neither system is exactly suited to our (English) requirements, or our characteristics. But the English system is like the American, in so far as it is based on principles of freedom." This remark of the Royal Commission on Railways of 1865-67[5] regarding the rate system of Europe and America applies equally well in the case of railway finance. Thus the general policy of the Board of Trade, the Government office which has much to do with railways, "has rather been to favor the utmost liberty to public companies to arrange their capital in any way they pleased."[6]

But at the same time the English Parliament recognized that for the public advantage it is desirable that a railway should yield a reasonable return to its investors.[7] When a railway pays little or no dividend on its capital, it has been feared that working expenses may be cut down injuriously, with the resulting disadvantages of insufficient or inefficient service. Then again, the embarrassment of one company in failing to furnish reasonable returns on its capital might discourage other investors from coming forward to put their money in the beneficial railway enterprise, which fact would result not only in the checking of the railway industry itself but in the hampering of the growth of all

[4] *Report of Royal Commission on Railways*, 1867, p. vii.

[5] *Report of Royal Com. on Railways*, 1867, p. lii.

[6] *Evidence before Select Committee on Railway Stock Conversion*, 1890, p. 37.

[7] *Report of Select Committee on Railway Borrowing Powers*, 1864, p. iii.

other industries and commerce in general. Furthermore, England has for years recognized the value of encouraging the circulation of capital, as shown by her effort to provide for the investment of all trust funds. These and other reasons led Parliament to attempt, from the beginning of railway enterprise, to regulate railway finance not for the direct interest of the government but for the security of the investors.[8] From a close study of the efforts of Parliament in regulating railway finance, one cannot fail to be impressed by the feeling that the English legislature has constantly borne this in mind.

There were in England, during the early years of its railway history, as there are now in the United States, many people who did not believe in government regulation of railway finance for the protection of investors. A leading lawyer in London said,[9] "I do not see why the Legislature should interfere to protect them (railway investors) more than other people. If they choose to take shares upon those conditions, it is their own affair." A prominent financial paper[10] also said that "as a principle, we believe there is nothing more objectionable than an attempt on the part of a government to find prudence for the people. It removes a great weight of personal and individual responsibility and caution, and creates a reliance on public officers as the only, however imperfect, substitute."

These opinions changed radically at times,[11] but gradually people began to appreciate the fact that certain regulations are indispensable for the protection of the investors in such a complicated business as railways, where it is well nigh impossible for the layman investor to ascertain the value or safety of securities issued, and where the confidence of the multitude of in-

[8] Report of Committee, April 24, 1837, p. xxvii, *Parliamentary Papers*, 1837, vol. 14, part 1.

[9] *Evidence before Select Committee on Railway Companies' Borrowing Powers*, 1864, p. 20.

[10] *Economist*, February 8, 1845.

[11] The *Economist* said that at one period, "men loudly complain of any impediment, however right it may be, which the restriction of acts of Parliament throw in their (railways') way," while at another time, "they evince the greatest impatience that Parliament will not at once disregard every general principle and interfere by compulsory means to put a stop to a course undertaken with their own free-will." *Economist*, April 11, 1846.

vestors has an immediate and serious effect upon the commerce of the whole nation.

This general policy has changed from time to time, although not as violently as it has in some other countries or as it has in the regulation of other branches of railway enterprise in England itself.[12] The change of policy has been due, on the one hand, to the change of public opinion and the circumstances of the time; and, on the other hand, to the changes within Parliament itself. It may be said safely that English railway policy has largely depended upon a varying and conglomerate body of legislators, "who may be assumed to have had no special familiarity with the subject on which they were legislating."[13] As Parliament has power to adopt any general or special measures to regulate any branch of railway enterprise as it sees fit, one may readily expect that occasional deviations from the adopted principles would be made.

The nature of the English system of regulation is also characteristic. Railway finance in England is regulated by two sets of rules:

A. General laws applicable to all companies.

B. Special laws applicable to particular companies.

The general laws are based on broad principles and are embodied in the general acts of Parliament. These general acts are applicable as a whole or only by incorporation in the special acts of the companies as the case may be. The special acts, which are enacted to govern individual companies, resemble the charters in the United States, but are obtainable only from Parliament by fulfilling certain requirements.

In the first place, the special act creates an incorporated company with all the corporate privileges attaching to such incorporation. In the next place, it gives power for, and prescribes rules governing the raising of capital. Then it grants the company the necessary powers to take land, lays down the rules governing meetings of the company, the construction of the road, and finally it defines the right of the public in using the railway. It also outlines the powers of the company, for example in charging tolls. The fact that out of a total number of forty-four sec-

[12] J. S. Jeans, *Railway Problems*, 1887, p. 64.

[13] W. W. Acworth, *Elements of Railway Economics*, 1905, p. 132.

tions of a recent railway bill [14] fourteen are devoted to financial matters, fairly indicates the importance attached by Parliament to the regulation of railway finance.

In these special acts are included not only the special regulations made to meet the individual conditions of the company, but also various provisions contained in the general companies acts. A clause is uniformly inserted to subject the company to "the provisions of any general act relating to railways now in force, or which may hereafter pass." [15]

It follows, as a consequence of Parliament having granted to each company in its special act its corporate privileges, that when the company desires to alter the terms of that incorporating act, to enlarge its original capital, or in any way to vary the conditions under which the capital is to be raised, a new application to Parliament becomes necessary.[16]

The most important of the general acts governing railway finance are the Companies Clauses Acts, 1845 and 1863, Railway Companies Securities Act, 1866, Railway Companies Act, 1867, Regulation of Railways Act, 1868, and Railway Regulation Act, 1871. All except the first two acts named above are applicable to all railways without incorporation in the special acts.

In the enactment of special acts, Parliament is guided by a set of standing orders as well as its model bills and clauses.

While the development of English legislation on railway finance has been a continuous one, still it may be divided into three periods. The years from 1801 to 1844 form the first period, 1845 to 1871, the second period, and 1872 to date, the third period.

Although railway finance has received much consideration from the beginning, during the first period it was regulated in a more or less haphazard manner. The legislative measures then taken were modelled after the special canal and turnpike enactments. There was no general law governing railway finance.

The second period, covering the twenty-seven years from 1845 to 1871, is by far the most important in the history of English legislation on railway finance. Concurrent with the railway

[14] The Coventry Railway Bill, 1910, now withdrawn.

[15] Standing Order No. 1686 of the House of Commons, 1906.

[16] *Report of the Royal Commission on Railways*, 1867, p. xlii.

mania and disastrous railway panics which formed a special feature of this period, the English system of financial legislation underwent rapid evolution and was subjected to repeated tests. The financial problems of railways formed a common topic of conversation and were kept constantly before the eyes of Parliament. Numerous inquiries were put on foot, and attempts made to bring the system of legislation to a higher state of efficiency. As a result of this unparalleled activity of both the public and Parliament, all the important general acts governing railway finance were passed during this period. The rules which were then adopted have remained unchanged, and few additions have been made. The regulations which England uses to-day in governing railway finance, with the single exception of the Railway Accounts Act of 1911, are exactly those adopted prior to 1871. Be these acts efficient or not, the fact that they have seen service for over forty years without being modified clearly indicates either one or the other of two theories. First, it may mean that the English system had been developed to such completeness prior to 1871 that no modification has become necessary or, secondly, it may mean that after the exertion during the sixties, the English have been undergoing a state of reaction and have since become too inert to modify these rules. While both hypotheses are to a certain extent permissible, history shows the first to be the more reasonable.

As has been indicated before, no legislation on railway finance has taken place since 1871. From that year on has been a period of application of principles already adopted during the first two periods. Stock-watering received consideration in 1890, but no general legislation or new principle was evolved. Moreover, the present outlook indicates that with the exception of some legislation on railway accounting, few material changes are likely to take place in the near future.

While the general purpose of all the legislation is to afford security to the investors, yet the place of emphasis of each period is distinct and different from those of the other periods. Thus the early legislation was largely for the purpose of insuring the *bona fide* character of railway enterprise before granting Parliamentary recognition and of demanding, though without a true understanding of its significance at the time, publicity of rail-

way affairs. Different from almost all other nations, as already stated, the English did not have trouble in inducing investors to embark in railway enterprises. On the contrary, she had to exercise considerable restraining influence. Thus the most prominent topic of legislation during the early period was the matter of preventing "bubble" schemes by securing an efficient system of subscription contracts and of requiring substantial deposits of money on each share subscribed, before permitting railway enterprises to receive Parliamentary sanction.

The question which received the greatest emphasis during the second period was how to restore the confidence of the investing public. The early regulations proved to be too indefinite, and railway finance was found to demand more public interference. Therefore, efforts were mostly directed toward finding methods of regulating railway finance rather than to the discovery of new principles.

Coming to the third period, we find the place of emphasis has returned to that of the first period, especially in the matter of publicity. The most important inquiries made during this period have invariably resulted in the demand for greater publicity. In spite of this similarity in emphasis, however, there is nevertheless a distinct difference, in that what has been done during the third period is more definite and has been done with a much clearer conception of what publicity means in the regulation of railway finance than during the first period. After forty years' experiment, England has remained where she was four decades ago, as far as the standing rules are concerned; but she seems to have determined upon the relative emphasis to be applied to her system of regulation in the future.

In tracing the historical development we find that prior to 1844 English legislation on railway finance was limited to the provisions embodied in the numerous private acts. Each company had its own special acts which contained the entire statute law applicable to the undertaking of that company.[17]

Early legislation was greatly influenced by the current conception of the railway as a turnpike. Time and again we find acts passed which dealt jointly with stage roads and railways as if the two were similar. The Duke of Wellington is said to have

[17] *Report of Royal Commission on Railways*, 1867, p. vii.

stated that in dealing with railways it was above all else necessary to bear in mind the analogy of the King's highways.[18] This remark, misleading as it appears now, was well representative of the current belief.

Then again, the early acts followed very closely in their general scope, the provisions which had been applied to canal companies. The earliest canal acts, however, gave no power of borrowing,[19] while the railways had been permitted to borrow from the beginning, to a certain extent. Thus the act of May 21, 1801,[20] the earliest railway act, providing for the construction and maintenance of a railway from Wandsworth to Pitlake, stated, "Proprietors may raise £30,000 by shares of one hundred pounds each, to be numbered and deemed as personal estate. Names of proprietors to be entered in a book, and tickets of their shares distributed to them. Proprietors may raise £15,000 more if necessary, by subscription or mortgage."

Before 1847 considerable laxity, however, prevailed in the manner of framing the provisions governing the raising of capital. But the great burst of railway extension in 1836 awakened some legislative activity, and the committees of Parliament on railway bills began to feel the necessity of enacting clauses conducive to the public welfare. A select committee was appointed to inquire into the matter, but no legislation took place.[21] However, the restrictions imposed by Parliament, in 1837 and subsequently on the obtaining of railway acts, temporarily arrested speculation.

In 1839 a select committee was again appointed to inquire into the state of railway communication, and as a result of its recommendations a general "saving" clause was inserted in the Croydon railway bill.[22] In 1840 another select committee was appointed by the House of Commons to inquire into railway af-

[18] C. F. Adams, *Railroads*, p. 82.

[19] The first act in which these powers appeared was passed in 1770. By degrees the borrowing powers of public companies were restricted to one-third of their share capital. See *Report of Royal Commission on Railways*, 1867, p. vii.

[20] 41 George 3, c. 33.

[21] *Quarterly Review*, v. LXXIV, p. 239.

[22] The "saving" clause inserted in the Croydon bill reads:

"And be it further enacted that nothing herein contained shall be deemed or construed to exempt the railway by this or the said recited acts

fairs.[23] Although no general legislation took place, committees seem to have done considerable good in throwing light upon the nature of railway transportation.[24]

Under this irregular system of legislation numerous charters were granted and liberal encouragements were sometimes given to the construction of railways. Then came that disastrous railway mania of 1844, and England "awoke one day" as C. F. Adams dramatically describes it, "from dreams of boundless wealth to the reality of general ruin." [25]

To see what could be done to improve the situation, a Parliamentary committee was appointed early in 1844. It recommended, and Parliament resolved that the following "saving" clause, which had been inserted in railways bills in 1839, should be uniformly inserted in all railway bills approved by Parliament. The clause was as follows: "And be it further enacted that nothing herein contained shall be deemed or construed to exempt the railway by this or the said recited Acts authorized to be made from the provisions of any general Act relating to such Bills which may pass during the present session of Parliament, or of any general Act relating to railways which may pass during the present or any future session of Parliament."

The committee gave to the question of railway legislation a more comprehensive consideration than it had hitherto received. As a result of the inquiries of this committee, provisions were

authorized to be made, from the provisions of any general act relating to railways which may pass during the present or any future session of Parliament." Hansard, v. 47, pp. 682-684. Compare with a similar clause resolved by Parliament to be inserted in all railway bills, since 1844, which appears in the next page.

[23] *Report of Royal Commission on Railways*, 1867, p. x.

[24] This committee was the first body of officials to point out to Parliament that the right reserved to the public by the early railway acts of running their engines and carriages on the railways was practically a dead letter, for the reason that (1) no provision had been made for ensuring to independent trains, etc., access to stations and watering places along the line, (2) the rates of charges limited by the acts were almost always too high to permit independent parties to work their trains, (3) the necessity of placing the running of all trains under the complete control of one management interposed much difficulty in the way of independent traders. *Ibid.*, p. x.

[25] C. F. Adams, *Railroads*, p. 85.

made, in the Railway Regulations Act, 1844,[26] for the suppression of loan notes which had been issued without legal authority during the period of rapid railway extension.

By this time the provisions of the special acts governing each company had become very complicated and numerous. The number of clauses contained in some of these acts had gradually increased from 95, as in the act for the Wandsworth and Croyden Railway, 1801, to 381, as in the act of the Lancaster and Carlisle Railway passed in 1844. As Lord Somerset[27] remarked in the House of Commons, there were an "immense" number of statutes relating to these railway matters which occasioned a great amount of uncertainty. In order to obtain greater uniformity in the general provisions inserted in railway acts and to render them more concise, the select committee of 1844[28] recommended that the numerous clauses in railway acts which "were common to all and undisputed" should be consolidated into a general act.

In the following year, Parliament following the recommendations of the select committee of 1844, for the first time passed three clauses consolidation acts, containing the clauses which were applicable to companies in general and which had been usually inserted in the private acts, as well as some other general provisions which Parliament deemed it desirable to enforce. This was done with the hope of securing uniformity. The acts, however, did not prevent committees of either house of Parliament from dispensing with some of these provisions in particular cases.

One of the three general acts had to do with the regulation of railway finance. This act[29] contained provisions for regulating the manner in which the companies' capital should be raised, the further borrowing of money, the rights and responsibilities of shareholders, the powers and duties of directors, the declaration of dividends, the keeping and auditing of accounts, and, in a general way, the manner in which the companies' financial affairs should be conducted.[30]

The expectations of the legislature in enacting the general act

[26] 7 & 8 V. c. 85 ss. 19-21.

[27] Hansard, v. 77, p. 170.

[28] *Report of Royal Commission on Railways*, 1867, p. xi.

[29] The Companies Clauses Act, 1845, 8 V. c. 16.

[30] See also *Report of Royal Commission on Railways*, 1867, p. xii.

were fully and quickly realized. The consolidation of the numerous clauses brought about a great degree of certainty and uniformity, and made the law more accessible and intelligible to the public.

It must be remembered that, at the time when the Companies Clauses Act, 1845, was passed, the great railway mania was at its height. The profitable returns afforded by the earlier railways attracted a large amount of capital. Consequently competing lines were proposed to most of the important centers of population. Parliament, as the report of the select committee of 1844 showed, sanctioned many such lines for the purpose of encouraging competition, with the belief that the remedy for the evil consequences of any monopoly which a railway was thought to possess, was to be found in the construction of a competing line.[31] "There has certainly never before been any one object of speculation," said the *Economist* in 1845, "into which all classes and ranks of men have entered so warmly as at this time into railways. There seemed to be no business too absorbing, no profession too grave, and no privacy too secluded, to be able to keep off this universal mania." [32]

Reaction soon followed action with equal force. The feverish railway extension led to a demand for capital for investment larger than the resources of the country could supply. As the railway fever was intense, so was the railway collapse complete. At the end of 1847 an act [33] had to be passed to extend the time for the construction of many railways, and in 1850 another act [34] to enable railway companies to abandon powers of proceeding with portions of their undertakings, and to release them from the conditions which had been attached to such powers. The complete collapse may be shown by the fact that of the 8,592 miles of railway sanctioned in the three sessions of 1845, 1846, and 1847, no less than 1,560 miles were abandoned under the power of the Railway Abandonment Act.[35]

The financial difficulties caused by the pressure for capital led the House of Lords to appoint a committee in 1849 to consider

[31] *Report of Royal Commission on Railways*, 1867, p. xvii.
[32] *Economist*, February 1, 1845.
[33] See *Report of Royal Commission on Railways*, 1867, p. xvi.
[34] Abandonment of Railways Act, 1850, 13 & 14 V. c. 83.
[35] *Report of Royal Commission on Railways*, 1867, p. xviii.

whether the railway acts did not require amendment, with a view of providing for a more effectual audit of accounts, to guard against the wrong application of the companies' funds.[36] This committee recommended, for the first time in railway history, the adoption of a uniform system of accounts and government audit.[37] No immediate legislation, however, took place.

These and other events which took place during the later forties and the fifties brought to light many new problems in railway finance, as a result of which additional provisions different from those contained in the Companies Clauses Act, 1845, were frequently introduced into railway bills. Accordingly, the Companies Clauses Act of 1863,[38] was enacted to extend the former clauses act. This act of 1863 contained four new principles, of which the first three had to do with railway finance. The first of these three related to the cancellation and surrender of shares, the second had to do with the creation of additional capital, and the third governed the creation and issue of debenture stocks.

During this period, the railways, in addition to their tendency toward extension, had a general policy of "buying up" every thing, in order to keep out all other lines from their own districts, at the same time invading as far as possible those of other lines.[39] This of course proved as costly to themselves as it was to their enemies. Heavy debts were contracted "for the purpose of securing old traffic against intruders and for developing new traffic for extensions and branches."[40] These struggles developed to such an extravagant extent that in spite of the favorable gross incomes, the dividends were low. Therefore, some shareholders "sincerely believed that if the Committee-rooms of the House of Commons were closed for five years, it would be the most important thing that had ever been done to protect railway property."

But Parliament apparently failed to realize clearly the serious nature of the situation. It had adopted a number of restrictions, but it failed to see to it that these restrictions were enforced.

[36] *Ibid.*

[37] Much attention was given to the question of uniform accounts. The subject will be taken up more fully in Chapters VII and VIII.

[38] 26 & 27 V. c. 118.

[39] London *Times*, February 9, 1863, p. 9.

[40] London *Times*, February 23, 1863, p. 8.

Consequently the speculative schemes as well as established companies found it quite easy to get around the Parliamentary restrictions. Men of straw were secured to sign up subscriptions for shares. Borrowed money was produced as paid-up portions of shares for deposit. Furthermore, not only was the legal limit of borrowing powers in many cases exceeded by the excessive issue of debenture, but a sort of note called Lloyd's bonds[41] was issued for amounts of money many times in excess of the statutory borrowing powers. As, according to the existing law, only the securities issued within the parliamentary limits were legal and hence valid, much confusion and difficulty followed the excessive issues, which in turn greatly damaged the credit of railway companies. Further money, consequently, was difficult to obtain.

Parliament, as most governments would do when in difficulty, appointed two select committees, one in 1863 and the other in the following year, to investigate the matter. These two select committees made a number of good recommendations for the betterment of railway finance, but no action was taken by Parliament to give effect to these recommendations until 1866, when the Companies Securities Act, 1866,[42] was passed, requiring, under penalty for failure, the railway companies to have registered officers and to deposit with the registrar of joint stock companies statements of their borrowing powers and half-yearly loan accounts. In the act were also set forth the particulars to be specified in these statements and half-yearly accounts. The act also prohibited railway companies from borrowing any money before depositing the statement of their borrowing powers just referred to. Moreover, the directors were required to declare "each for himself" on every mortgage deed or bond, or certificate of debenture stock, that the specific security was issued under the borrowing powers of the company as registered.

This measure, useful as it has proven to be, was far from being effective in dispelling the chaos. The "arcadian simplicity of the early times" where most railway bills before Parliament rep-

[41] They are a sort of railway exchequer bonds, representing what in the United States is called a floating debt, which is to be capitalized and paid off sometime or other. They bear the name of the parliamentary draftsman who originated them.

[42] 29 & 30 V. c. 108.

resented the enterprise and capital of a number of *bona fide* investors had long passed away. Instead, the "speculative element" prevailed. Subscription of railway shares actually became, in some cases, a process of "selling in the market of the powers conferred by the Legislature."[43] Contractors' schemes, instead of railway corporations, became the center of railway activity. These contractors' schemes soon became unable to support their undertaking, and they had to resort to the "finance" companies[44] for help. As the latter were nothing but paper creations of credit, founded on works that were not or could not be completed, and as these finance companies themselves offered no security, the result could be readily foreseen. Not only did the finance companies fail to bolster up the contractors' schemes, but they were both dragged down to mutual ruin.[45] Thus came the terrible collapse of 1867. There was so much confusion and distrust of what was taking place in the railway companies, "that all which the railway boards now say is searched between the lines; is suspected of ambiguity even when plain; is taken in a sense unfavorable to the railway when doubtful; is believed when it is against the board, and disbelieved when for the board."[46]

The panic was a bitter, but a beneficial lesson, as a result of which several fundamental principles were evolved. It was realized[47] that the difficulties were to a great extent caused by the mistaken view taken by Parliament originally in copying the provisions of the old canal bills for the regulation of railway finance, without taking account of the difference between the securities issued by the canals and those by the railways, and without weighing the consequences of so large an amount of permanent works being provided for by a floating instead of a fixed debt.[48] With the idea that a railway, like a canal or a turnpike

[43] London *Times*, May 15, 1866.

[44] These finance companies were formed for the avowed purpose of providing the capital which would enable the contractors to carry on their works. See Hansard, vol. 183, pp. 857-858.

[45] *Ibid.*

[46] *Economist*, December 21, 1867.

[47] Hansard, vol. 185, pp. 784-785.

[48] Under the canal bills, the loans raised were precisely like mortgages of any other landed estates and were usually for seven or fourteen years, and the total amount was said to be small. Under the railway bills, altogether over £120,000,000 had been taken from the floating capital of the country

road, was to be open to all the world, so that anybody might place his own engines and carriages on the line and run them, on condition that he paid the company certain tolls for the privilege, Parliament, in granting a lien on the tolls, gave what it then considered to be as good a security as the mortgage on a landed estate.[49] Therefore, the security for railway debentures was made to cover only the permanent road-bed and the tolls, as railway charges were then called, of the undertaking; and the rolling stock was excluded.

The revelations of 1867 made clear the vast differences between the railways and the canals, and made Parliament realize the desirability of extending the lien of railway debentures to the rolling stock of the companies. Consequently the Companies Arrangement and the Debenture Holders Bill were introduced in the session of 1867. After considerable deliberation by a special committee the two bills were fused, as they were, into the Railway Companies Bill. The purpose of the bill, as outlined by the Duke of Richmond, was to give greater security to railway property and to all classes of shareholders.[50]

The procedure connected with the passage of this "finance" bill was entirely different from that connected with the bills of former years. It received a very thorough investigation in the committee as well as in both houses of Parliament. Indeed, the bill came out from the committee room in a very different form from that in which it was originally sent. The committee discussed every clause in the bill and had a division upon almost every one of the clauses. There was so much objection on all sides, that "if all their objections prevailed, there would not be a single clause left in the bill." [51]

The bill received royal assent in August, 1867, and became the Railway Companies Act of that year.[52] The novel, and by far the most important feature of the Act, was the provision made for the protection of the rolling stock and plant from seizure,

under much shorter dated securities, which were not mortgages in the usual sense of the term and could not then be held by trustees. According to H. C. E. Childer, Hansard, vol. 185, pp. 784-785.

[49] *Ibid.*, p. 786.

[50] Hansard, vol. 188, pp. 489-490.

[51] *Ibid.*, pp. 157-161.

[52] 30 & 31 V. c. 127.

thus affording additional security to the debenture-holders and insuring the convenience of the public. Besides providing for the creation and issue of debenture stock and new capital, and stipulating the rules governing the abandonment of railways, the act made it possible for the companies to adopt "schemes of arrangement" in case they became unable to meet their engagements.[53]

Moreover for the first time all restrictions upon the rate of interest on debentures were removed, and henceforth the companies were given the liberty to arrange and pay whatever rate of interest suited them best instead of being handicapped by the rate sanctioned by Parliament, as had been the case before.

Another new provision introduced was that no dividends should be declared until all accounts of the company were audited and a declaration made by the auditors to the effect that the proposed dividends were *bona fide*.

Just about this time, the Royal Commission on Railways of 1865-1867 made its report, in which special attention was called to the importance of a uniform system of accounts for the effective regulation of railway finance. Although its work has often been regarded as a failure,[54] its conclusions regarding the importance of uniform accounting have proven sound and of great value.

Almost simultaneously with the report of the Royal Commission; the railways and the public also became aware of the great importance of adopting some uniform system of accounts. Members of Parliament began to realize the inadequacy of the old system which permitted each railway to adopt its own system of accounts and to keep it in its own way. This irregularity in accounting was recognized not only as one of the causes of the panic, which was then not yet over, but was considered as undesirable in itself. It was quite generally recognized [55] that there was no cure for the mischief of delusion, nor any hope for railway property, except by the introduction of a principle of accounting in which nothing would be admitted as profit but the

[53] Hansard, vol. 189, p. 159; also see ss. 6-22 of Act.

[54] A. T. Hadley, *Railroad Transportation*, 1903, p. 169.

[55] London *Times*, November 8, 1867, p. 6.

surplus of actual receipts over actual expenditures. Consequently much agitation took place. A number of bills [56] for the regulation of railway accounts were introduced into Parliament as a result of which the Regulation of Railways Bill, 1868, was prepared and introduced by the Board of Trade. In preparing this bill, the Board of Trade not only gave careful consideration to the recommendations of the Royal Commission on Railways and took advantage of the experience of the previous years, but consulted frequently a number of railway accountants and other experts. Parliament also gave the measure unprecedented attention. It no longer, for the time being at least, had any fear of general and sentimental opposition to sane measures on this subject. The only question before it, therefore, was what should be done to restore to railways their lost confidence and what measures should be adopted to prevent future malversation in railway finance.[57]

Under such favorable circumstances, the bill received unusually careful consideration instead of the former party quibbles, and obtained royal assent in July, 1868. Henceforth all railway companies were required to prepare and present, semi-annually, a statement of accounts and balance sheets according to the forms perscribed. The officers were subjected to severe penalty for falsifying such accounts or statements. A system of government inspection and audit was also adopted.

The part of the act dealing with accounts and audit was at once recognized as of a novel nature, and hence received much discussion.[58] In spite of the fact that the act contained seven parts, of which only one dealt with accounts and auditing, it has been called, with good reason, an accounting act. Although the general usefulness of a uniform system of accounts was felt, the true import of such a system was not fully recognized. Much less was it recognized that this measure was to be the culmination of a century's work in legislation on railway finance. Nevertheless, this was the case. With the exception of the enactment of the Railway Regulation Act, 1871,[59] dealing with railway statis-

[56] The Railway and Joint Stock Companies Account Bill and the Companies Audit of Accounts Bill, etc.

[57] Hansard, vol. 191, p. 1536.

[58] *Economist*, March 21, 1868.

[59] 34 & 35 V. c. 78.

tics, and the insertion, since 1890, of some special clauses in the special acts governing the watering of stocks, no general legislative measure has been adopted since. Even the somewhat antiquated requirement of semi-annual accounts as well as the forms of these accounts adopted prior to 1871 have been in use until very recently. The system of accounts had, indeed, for some time been recognized as inadequate and a departmental committee with a number of well known economists, statisticians, and accountants as members, recommended in 1909 its modification. A bill was actually introduced to give effect to the committee's recommendation, but nothing had been done until 1911 when a new accounts act was passed.[60] Hence with little qualification, we may say that English legislation on railway finance was closed by the passage of the Railway Regulation Act, 1871, and with the exception of accounting what guides England to-day in regulating the financial affairs of her railways is exactly what guided her four decades ago.

To describe briefly the present scope of English legislative control of railway finance, we may say that before incorporation, the *entrepreneurs* are required to produce sufficient evidence that all the proposed share capital has been subscribed for by *bona fide* investors and that a deposit varying from 5 to 10 per cent of the total estimated cost of the undertaking has been made. The conditions under which the share capital may be raised and the privileges and responsibilities of the subscribers, as well as the rules governing the issue, cancellation, and surrender of such shares are prescribed in detail. Preference shares with a fixed rate of dividend may be issued according to the regulations laid down by Parliament, and ordinary shares may be "split" into preferred and deferred portions under certain conditions. Stock-watering is permitted, but it must be done in the open, and a record of such operations must be made in the company's accounts.

The companies are given power to borrow on mortgage to the extent of one-fourth of their total paid up capital. But such borrowing powers are not to be exercised until all the shares of the company are taken and one-half of the total on such shares has been paid up. Only the securities issued within the statu-

[60] 1 & 2 Geo. V, Cap. 34.

tory limits are regarded as legal securities, to enjoy the special privileges given by law to mortgages.

In incorporation and in raising additional capital, the companies are required to state in each and every case the purpose for which money is raised, and they are prohibited from applying any money so raised to purposes other than those approved by Parliament.

Annual accounts of all the incomes and expenditures are to be kept according to the uniform system of accounts adopted in 1868, as revised in 1911, and annual statistical returns must be made to the Board of Trade according to the rules prescribed in the Railway Regulation Act of 1871 and the Railway Companies (Accounts and Returns) Act of 1911. Government audit and inspection of the company's affairs may be resorted to under certain special circumstances.

Aside from these restrictions, the English railways are permitted to do as they please in managing their financial matters, subject to the common law of the country. But Parliament has power to pass any general law governing railway finance as it sees fit. Railway companies may change their original terms of incorporation, or vary the conditions under which their capital may be raised or spent, or effect any other modifications regarding financial affairs; but in each and every case, they are required to apply to Parliament for special permission.[61]

England, we have stated, undertook to regulate railway finance long before some other countries realized the importance of this branch of government activity. Thus, it may well be asked in the beginning, (1) Why did England deem such actions necessary? and (2) what led her to adopt her unique policy? The first question may be answered by stating that England has long recognized that public advantage requires that railways should

[61] In practice, the permission can usually be obtained without any difficulty, if there is no serious opposition. The following passage from an editorial of the *Economist*, April 9, 1870, to a large extent expresses the situation:

The "position (of Parliament) towards applicants for powers is very simple. It is the mere dispenser of an authority which the applicants wish to possess, and which it confers upon them in order that the country may gain. Both parties are quite free in the matter. The companies to make a profit apply for the power, and Parliament believing that its constituents will gain, assents to the demand."

yield reasonable returns to those who invest in such undertakings and that a certain amount of government interference is required to help investors to identify the securities issued by railway companies, which they are asked to take up. To raise a sufficient barrier against swindling operations and to protect the public from "bubble" schemes, seem to be objects underlying all the legislative actions of Parliament.

In answer to the second question as to why Parliament has adopted its particular policy in regulating railway finance, it may be said that although Parliament attempted to adopt more stringent measures for realizing the purposes just referred to, it was constantly reminded of the fact that England is a country of free enterprise. The general principle was well established that the state should interfere as little as possible with what is being or is capable of being performed by private enterprise. There has been even considerable cry that "the cost of a railway is a matter with which the public and Parliament have no concern." [62] The idea that an enlightened view of their own interest would always compel railway officers to have due regard to the general advantage of the public has always been kept prominently before the attention of the government. Moreover, Parliament is an elective body, and has consequently been influenced by popular conceptions in dealing with such scientific questions as the regulation of railway finance.

Moreover, by the time Parliament had fully realized the importance of more strict regulation, its *laissez faire* rules had been established, and an enormous amount of capital already invested in the railway business. Parliament therefore felt that it would be unjust to withdraw in any way the early concessions which led to the investments. The constant desire to make railway investments safe securities on the one hand and to interfere with railway management as little as possible on the other, seems to have caused Parliament to adopt its unique system of regulation of railway finance which seems to differ from that of all other countries.

[62] London *Times*, June 4, and June 12, 1886.

CHAPTER II

LEGISLATIVE SUPERVISION OF CAPITALIZATION

A — SHARE CAPITAL

The greater part of English railway capital is raised by the issue of three classes of instruments,[1] varying in security and interest. The net income is liable in the first instance to the claims of the debenture holders, then to those of the holders of preference shares, and ultimately to those of the holders of ordinary shares.[2]

In general a railway raises its capital in the first instance by issuing ordinary shares. When this class falls to a discount, or for some other reason, the company has recourse to inviting subscriptions to preference or guaranteed shares. The holders of the latter class of stocks are, to a certain extent, not only proprietors but semi-creditors of the company, in that the net income of the company is first of all secured to them in priority over the ordinary stock holders. When the ordinary and preference stock are both taken up and, theoretically, paid for in cash to the amount of the nominal value, then the company may use its authority, granted by Parliament, to borrow money on debenture, mortgage, or otherwise, to the extent of one-third of the amount raised by shares or one-fourth of the total capital.[3]

Among the several important features into which the parlia-

[1] Formerly railway securities were divided into five classes: ordinary, guaranteed, preferential, loans, and debenture stock. About 1870, the second and third classes as well as the fourth and fifth classes were merged. In addition to these principal classes, there are also various subordinate issues such as rent charge stocks which are practically guaranteed stocks, and preferred and deferred stocks. The latter two, however, are but components of the ordinary stock. There is another very rare class (according to Wm. J. Stevens, *British Railways*, p. 4), called the contingent right stock which shares in dividends with the ordinary stock after a certain rate on the latter has been paid.

[2] See London *Times*, August 27, 1871.

[3] *Cf.* John Fraser, *British Railroads*, 1903, pp. 26-27.

mentary committee on railway bills would make inquiry before recommending the passage of such bills were the financial affairs of the applying company.[4] They would scrutinize, first of all, the amount of the capital to be raised by the company, whether by the creation of shares or by loans. Thus besides considering the location and nature of the line, special engineering difficulties, expected traffic, etc., the committee on railway bills in 1844, as in the case of the Brighton and Chichester Railway, considered carefully the following questions:[5]

1. The amount of the proposed capital and the amount of loans to be raised.
2. The amount of shares subscribed for and the deposits paid thereon.
3. The names and places of residence of the directors with the amount of shares taken by each.
4. The number of shareholders who might be considered as having a local interest in the line, and the amount of capital subscribed by them, together with their names and addresses.
5. The number of other shareholders and the capital taken by them.

It was only after being satisfied with respect to these points as set forth in the bill, that the committee would recommend its passage. The manner in which these provisions governing share capital of railway companies were embodied in the special acts is illustrated by the following passages from the London and Croydon Railway Act of 1837:[6]

"CXXXVI. And whereas the probable expense of making the railway and other works hereby authorized will amount to the sum of £1,800,000, and sums exceeding that amount have been subscribed under the subscription contracts . . .; be it enacted, That, notwithstanding any thing in the several subscription deeds or contracts . . ., the capital of the company hereby incorporated shall be £1,800,000 divided into 36,000 shares of £50 each; and that such shares shall, as soon as conveniently may be after the passing of this act, be apportioned and divided to and amongst the several provisional Committees or provisional Directors . . ., in the proportion herein-before mentioned. . ."

The act further permitted the company to increase the number of shares by diminishing the amount in value of each share

[4] *Railway Times*, October 5, 1839.

[5] *Ibid.*, April 25, 1844.

[6] Hereafter called the Croydon Railway Act.

in order to facilitate the allotment of such shares among the subscribers.

As these clauses became numerous and complicated Parliament consolidated them and a number of other provisions into general provisions to be applicable to all companies. Thus in the Companies Clauses Act, 1845, provisions were made to the effect that the capital of the companies should be divided into shares of the prescribed number and amount and that such shares should be numbered in arithmetical progression.[7] All the provisions as being outlined in the private act just referred to were also set forth with precision. Further provision was made to enable railway companies to convert their borrowed money into share capital under certain conditions.[8]

In England, as in other countries, the railways were given compulsory power to take land; but they were not allowed to exercise such power until they produced a certificate under the hands of two justices certifying that the whole of the capital or estimated sum for defraying the expenses of the undertaking had been subscribed under contract binding upon the subscribers.[9] Companies were also forbidden to reduce their capital by the payment of dividends;[10] but they might reduce their capital in case the commissioners of railways authorized the abandonment of a part of their undertaking and the commissioners favored such a reduction of capital.[11]

As has been referred to, the Companies Clauses Act of 1845

[7] Companies Clauses Act, 1845, 8 V. cap. 16.

[8] "56. It shall be lawful for the company, if they think fit, unless it be otherwise provided by the special act, to raise the additional sum so authorized to be borrowed, or any part thereof, by creating new shares of the company, instead of borrowing the same, or having borrowed the same, to continue at interest only a part of such additional sum, and to raise part thereof by creating new shares; but no such augmentation of capital . . . shall take place without the previous authority of a general meeting of the company.

"57. The capital so to be raised by the creation of new shares shall be considered a part of the general capital, and shall be subject to the same provisions in all respects, whether with reference to the payment of calls, or the forfeiture of shares on nonpayment of calls, or otherwise, . . ."

[9] Lands Clauses Act, 1845, 8 V. cap. 18, ss. 16-17.

[10] Companies Clauses Act, 1845, s. 121.

[11] Abandonment of Railways Act, 1850, 13 & 14 V. cap. 83, s. 28.

required that the capital of the companies should be divided into shares of the prescribed number and amount. The holders of the shares were entitled to enjoy the proprietary privileges according to the number of shares owned,[12] and were at liberty to transfer their shares. A provision, however, was inserted in the Companies Clauses Bill, 1845, to the effect that no shareholder should make any transfer of shares in respect of his subscription until he had paid all calls for the time being due on such shares held by him.

This provision met with much opposition in Parliament. It was objected to on the ground that it was not only too hard a measure, but it would prevent the solvent shareholder from disposing of his shares until all the calls were paid up, thus giving an advantage to the insolvent holders, as it did not matter much to the latter whether he effected a transfer or not. It was contended that a call might be made for a particular day, and it would not be proper to prohibit the transfer of shares in the interim.[13]

To this objection, it was retorted that a call once made would form a debt, and hence should be settled first. It was further urged that the adoption of the clause would put an end to the extremely harmful practice of railway speculation which was very common at the time. These speculators, it was pointed out, would often enter into engagements without the least probability of their ever being able to meet them; and when they became deeply involved for calls, they would shake off their responsibility by transferring their shares to men of straw. Thus after considerable discussion, the clause was agreed to.[14]

Further provisions, however, were made in the early special acts, to the effect that transfers of shares and stocks should be made by deed and should be registered in the registers of the companies concerned, and that until such registration was made,

[12] On account of the fact that many people subscribed to shares without any idea of ever paying for them, a provision was made in the Railway Construction Facilities Act of 1864 (27 & 28 V. cap. 121, s. 28) to render it unlawful for any company to issue any share created under the authority of a certificate of the Board of Trade nor should any such share vest in the person accepting the same, unless and until a sum not less than one-fifth part of the amount of such share had been paid up.

[13] Hansard, vol. 77, p. 929.

[14] *Ibid.*

the seller of the share should remain liable for all the calls and the purchaser should have no part or share of the profits of the undertaking, nor any voting power in respect of such transferred shares.[15] Forms of certificates of both shares and transfers of shares were also prescribed.

So far so good; but Parliament seemed to have failed at the most important point. It did not stipulate the time within which such registration should be executed. When the prospects of a company were good, the proviso that failure to register would deprive the purchaser of his proprietary privileges was sufficient to insure proper expeditious registration, but when the prospects of a company were bad, it was entirely different. Consequently, purchasers of railway shares often would hold the transfer in their possession so long as it suited their convenience; the seller of those shares having no means of compelling the purchasers to register the share, would remain always liable for the payment of the calls. The law subjected these sellers to the liability of paying calls, but afforded them no means of repossessing themselves of their shares.[16] Consequently the original holders having disposed of their shares in the market and after the lapse of years when call upon call had accumulated to a frightful amount, were sometimes subjected to legal proceedings, "because none of the many parties through whose hands these shares had subsequently passed had chosen to render themselves liable by conforming with the requirements of the company's act."[17] The brokers also took advantage of this unfortunate situation by arranging schemes whereby it was made possible that from the moment the deed was stamped for the first time, the transfer should pass from hand to hand possibly for many months without the payment of any duty upon the several transactions subsequent to the first.[18]

The inconvenience resulting from such illegal transfer of shares was seriously felt.[19] Therefore, it was urged before the

[15] Companies Clauses Act, 1845, ss. 14-15, and s. CLV of the Croydon Railway Act, 1837.

[16] Evidence before the select Committee of the House of Commons, 1839. *Railway Times*, November 9, 1839.

[17] *Railway Times*, November 9, 1839.

[18] Second Report of select committee of the House of Commons, as appeared in *Railway Times*, October 5, 1839.

[19] *Railway Times*, November 9, 1839.

select committee of 1839 that some measure should be adopted to limit the period within which transfers of shares and stocks should be registered.[20] It was also suggested that unless registration was made within the specified time, the transfer should lose its validity and the share should revert to the selling party.[21] No action, however, was taken by Parliament to effect these reforms. But in 1850, a provision was made in the Abandonment of Railways Act of that year,[22] again providing that unless a share had been duly registered and calls on it fully paid, it would not entitle its holder to the proprietary privileges. No provision, however, was made to stipulate a uniform limit of time within which such registration should take place. Hence the regulations governing the registration of transfer of shares remained as defective as before, and nothing further has been done since.

The payment of calls also received much consideration in 1845. Companies were empowered by the Companies Clauses Act of that year [23] to make calls for the payment of money upon the shareholders by serving on each shareholder a notice at least twenty-one days before making the call; but no successive calls should be made at less than the prescribed intervals. The aggregate amount of calls made in any one year was also prescribed. Every shareholder was held liable to pay the amount of the calls made in respect of his shares; and in case of failure to pay such calls on or before the proper time, he should be liable to be charged with interest for such unpaid calls at the legal rate. The railway companies were further empowered to sue and recover with interest from such defaulting shareholders the amounts of the calls due, for which purpose the production of the register of shareholders was *prima facie* evidence of such defaulting parties being shareholders of the company and of the number and amount of their registered shares.

Moreover, the directors after serving proper notice might at any time after the expiration of two months from the day appointed for payment of such calls, declare the forfeiture of such defaulted shares on which calls were due and unpaid. After

[20] *Ibid.*
[21] *Ibid.*
[22] 13 & 14 V. cap. 83, s. 6.
[23] 8 V. c. 16, 21-28.

such declaration of forfeiture being confirmed by a general meeting the company might sell such forfeited shares.[24] To safeguard the interest of the shareholders, however, it was provided that no [25] company should sell or transfer more of the shares of any such defaulters than was sufficient to pay the arrears, etc., then due from them. In case the money produced by any such sale was more than what was needed to pay for such arrears, interests, etc., the defaulters might claim the surplus.

The matter of cancellation and surrender of shares was further amplified by the Companies Clauses Act, 1863,[26] so as to give the companies greater liberty in such matters and to make the payment of calls of even greater consequence to the shareholders.[27]

Provision was also made to the effect that the last registered holders of such forfeited shares should not only be precluded from all rights and interest in respect of such shares, but should also be held liable to pay all arrears of calls, interest, and expenses due in respect of the share at the time of the cancellation, notwithstanding such forfeiture.[28]

Moreover, companies were authorized to cancel forfeited shares with the consent of holders and to accept, on such terms as they saw fit, surrenders of any shares which were not fully paid up; but they were forbidden to "pay or refund to any shareholder any sum of money for or in respect of the cancellation or surrender of any shares." [29]

[24] *Ibid.*, ss. 29-33.

[25] *Ibid.*, ss. 34-35.

[26] 26 & 27 V. c. 118, s. 4.

[27] Section four of this act provides: "Where any share . . . is after the passing of this act declared forfeited under and in pursuance of the provisions . . . in The Companies Clauses Consolidation Act, 1845, . . . and the forfeiture is confirmed by a meeting in accordance with the same provisions, . . . and notice of the forfeiture has been given, — then, . . . if the directors of the company are unable to sell the share for a sum equal to the arrears of calls and interest and expenses due in respect thereof, the company at any general meeting held not less than two months after such notice is given may, in case payment of arrears of the calls, interest and expenses due in respect thereof is not made by the registered holder of the share before the meeting is held, resolve that the share instead of being sold shall be cancelled, and the share shall thereupon be cancelled accordingly."

[28] 26 & 27 V. c. 118, s. 6.

[29] 26 & 27, c. 118, s. 10.

When a railway company desired to raise additional capital, it should apply to the Board of Trade for permission,[30] and the latter after being satisfied that the applying company had complied with the requirements of the established rules governing notices, etc., might settle a "draft of certificate" to authorize the company to raise the prescribed amount of additional capital for the purpose set forth in the certificate. For the purpose of raising such additional capital, the company was at liberty to issue new shares or stock or to make loans, unless the certificate provided to the contrary.[31] New shares or stocks issued under such circumstances, or for the conversion of its loans into share capital, as well as for raising additional sums of money in lieu of borrowing should be considered as a part of the general capital and should be subjected to the same provisions in all respects as the existing shares, except as to the time for making calls and the amounts of such calls, which the company was authorized to determine as it saw fit from time to time.[32]

In order to safeguard the interests of the shareholders, it was provided by the Companies Clauses Act of 1845 [33] that if at the time when the augmentation of capital took place the existing shares were at or below par, the new shares might be of such amount and issued in such a manner as the directors saw fit, but that if at the time of the augmentation the existing shares were at a premium, then, unless it was otherwise provided by the special act of the company, the sum to be raised should be divided into shares of such amount as would conveniently allow the same to be apportioned among the shareholders in proportion to the existing shares, and such new shares should be offered to the existing shareholders in the proper proportion by letter.

The latter provision, beneficial as it was to the shareholders, seemed to have been more or less abused by some of the shareholders through their neglect in acknowledging their acceptance of such offers. Consequently, a similar provision was made in the Companies Clauses Act, 1863,[34] with the proviso that in case the company's offer to any shareholder was not accepted within

[30] Railway Companies Act, 1864, 27 & 28 V. cap. 120, s. 3.

[31] *Ibid.*, s. 4 and Schedule iii.

[32] Companies Clauses Act, 1863, 26 & 27 V. cap. 118, s. 12, and Companies Clauses Act, 1845, 8 V. cap. 16, ss. 56-57.

[33] Companies Clauses Act, 1845, 8 V. cap. 16, ss. 58-60.

[34] 26 & 27 V. cap. 118, ss. 17-21.

the time limit and in the absence of any special arrangement to extend such time limit, then the company might dispose such new shares and stocks in whatever way it saw fit, "but so that not less than the full nominal amount of any share or portion of stock be payable or paid in respect thereof." The latter provision prohibiting the disposal of shares at a discount, however, was repealed afterwards.

In several of the bills of the session of 1859 and 1862, power was sought to accept surrenders of shares liable to be forfeited, and to extinguish, without sale, the interest of the holders of shares which had become forfeited, and thereupon to cancel or merge the surrendered and forfeited shares, and in lieu of such cancelled shares to issue new shares to an aggregate amount, limited in some cases to that remaining unpaid in respect of the cancelled or merged shares, and in others extending to the aggregate amount of the whole of the cancelled or merged shares.[35] The Board of Trade thought that such irregularities were undesirable, and during those years repeatedly urged that the aggregate amount of the new shares which might be issued in lieu of the old shares should in all cases be restricted to the aggregate amount remaining unpaid in respect of the cancelled or merged shares, so that the sums which had been already raised by means of the old shares might not be raised a second time. It believed that if further sums were required for the companies' undertaking, it would be better that authority to raise them should be sought as a power to raise additional capital, for by so doing the nominal capital of the company would correspond with the amount which the company would have been authorized to raise by shares if the cancellation or merging did not take place.[36]

Following these repeated recommendations of the Board of Trade, Parliament inserted a clause in the Companies Clauses Act, 1863,[37] to the effect that the companies might issue new shares in lieu of cancelled or surrendered shares; but the aggregate nominal amount of such new shares should not exceed that of the old shares after deducting the amount actually paid up in respect of such old shares.

[35] Report of Board of Trade on Railway Bills, 1861, pp. 22-23.

[36] *Ibid.*

[37] 26 & 27 V. c. 118, s. 11.

By the same act,[38] railway companies, after having created new shares or stock, were permitted to cancel such new shares or stock should they decide not to issue the whole of such new shares.

As stated above, between the ordinary shares and the debentures or loans of a company are the preference shares. The latter bears a specified rate of dividend which shall be met out of the company's net income before any ordinary shareholder may receive any dividend. Prior to 1863, the interest or guaranteed dividend on these preferential shares was cumulative. If it is not paid in one year, then it must be paid together with the dividend due in the succeeding year in full, before the ordinary stocks could receive anything. But in the Companies Clauses Act, 1863,[39] a provision was inserted to the effect that preference shares should be entitled to dividends only out of the profits of each year; and if any year ending on the 31st of December, "there are not profits available for the payment of the preferential dividend . . . for that year, no part of the deficiency shall be made good out of the profits of any subsequent year, or out of any other funds of the company."

With regard to the creation and issue of preferential stocks, the same act[40] provided that where any company was authorized by any special act to raise any additional sum by the issue of preference shares or stock with the sanction of a general meeting it might create and issue (according as the authority given by the special act extends to shares only, or to stock only, or to both) such shares or stock as the company from time to time saw fit. It was, however, further provided that such stock should not affect any guarantee, or any preference or priority in the payment of dividend or interest, granted by the company under, or confirmed by, any previous act.

The act also required that the terms and conditions to which any preference share or stock was subjected, should be clearly stated in the certificate of the preference share or portions of the preference stock.[41]

[38] *Ibid.*, s. 16.
[39] 26 & 27 V. c. 118, s. 14.
[40] 26 & 27 V. cap. 118, s. 13.
[41] Companies Clauses Act, 1863, 26 & 27 V. c. 118, s. 15.

After the adoption of those provisions regarding preference shares, there was for a number of years a constant tendency for the proportion of preferential capital to grow more rapidly than that of the ordinary capital. Thus in 1858 the ordinary and preference capital were outstanding in the proportion of 56 to 44, while in 1870 and 1871 the relative proportions were reversed, becoming 43 to 57 and 42 to 58 respectively.[42] Such changes might have been brought about by two entirely different causes. In the first place, when railway enterprise became established, it might be reasonably expected that the preference capital would tend to increase more rapidly than the ordinary. When a railway pays large dividends on its ordinary shares, it can raise money on easy terms by issuing preference or debenture stocks at fixed rates of interest. This seems to have been largely the case in England. On the other hand, when a company pays little or no dividend on its ordinary shares, it will be compelled to resort to the issue of such preferential shares for raising money, in order to avoid heavier sacrifices.

Another class of shares or rather another nomenclature given to the ordinary shares, known as preferred and deferred shares, has come into vogue since 1868. These, in reality, do not constitute any separate class of shares, but simply represent two divisions into which the ordinary shares are divided. All the rules governing the ordinary shares are also applicable to these preferred and deferred stocks, except that special rules have been adopted to govern the process of, and the conditions under which, the division may be executed.

The first known instance of "stock splitting," by which the ordinary shares are divided into preferred and deferred, took place in 1854 in the case of the Great Northern.[43] During that year £12 having been paid on each £20 share of that Company, a panic seized upon the public mind and grave doubts were entertained as to whether the boldly competitive scheme of that company could be successful in the face of adverse circumstances. At the same time the London and North-Western authorities were not slow to take advantage of the situation in making things uneasy for their competitors. In order to push the thing

[42] *Capt. Tyler's annual report to the Board of Trade*, 1873, p. 4.
[43] *Railway Times*, May 2, 1868.

along, the directors of the Great Northern adopted the proposition, — not to forfeit the shares and confiscate the whole of the payments thereon, — but to lay aside £10 for the defaulting subscribers, and to give the remaining £2 as a bonus to future subscribers with the whole of a dividend up to 3%, calling the holdings of the old subscribers, B., or deferred, and those of the new subscribers, A., or preferred stocks. This procedure speedily restored confidence in the undertaking and carried it through its vicissitudes.

This affair received considerable attention; but it was not until 1868 that stock splitting became a burning question. In that year, the South Coast and other companies applied for power to divide their ordinary stocks into preferred and deferred ordinary, at the option of the shareholders.[44] Consequently strict regulations were adopted in the Regulation of Railways Act of that year [45] specifying with great elaboration the precise conditions under which the division of stocks might be effected.

There was no debate on this clause; but there was one in the House of Lords on a similar clause of the South Coast Railway Bill of that year just referred to, from which the clause in the Regulation of Railways Act was copied. When the South Coast Railway Bill was in the House of Lords, the clause giving power for splitting stocks was struck out. But when the bill was considered in the House of Commons, the original clause was reinserted in the bill. Finally when the bill came back to the upper house of Parliament again, a motion was again made to omit that clause. Lord Redesdale very strongly opposed the division of stocks, on the ground that such a practice would favor stock jobbing.[46]

On the other hand, the Duke of Richmond, who was then president of the Board of Trade, supported the clause on general principles. He maintained that "the tendency of Parliament had been not to interfere with the financial arrangements of these companies; providing, of course, that Parliament saw that no injustice was done to mortgages, or other parties. . ." He

[44] *Evidence before Select Committee on Railway Stock Conversion*, 1890, p. 37.

[45] 31 & 32 V. c. 119.

[46] Hansard, 193: 1545.

further claimed that to prohibit the splitting of stocks was entirely opposed to the recommendations of the Railway Commission,[47] which went very fully into the question, and gave it as their opinion that it was the more judicious course for Parliament to relieve itself from interference in the financial affairs of railway companies. Instead of proving injurious, he believed the proposed subdivision of stocks would tend to give all parties concerned an additional interest in seeing that the directors did their duty.[48]

After considerable discussion, the clause was adopted with thirty contents and seven non-contents.[49] Since then the regulations governing the splitting of shares have been elaborated but not modified, and railway companies have been given the liberty to divide their shares under these or similar regulations.[50]

Commenting upon this clause, the *Railway Times*[51] said that it was certainly to be regretted that "the Legislature should have lent itself to a system capable of further propagation of so vile a mischief," and it concluded that "we have only to hope that the nuisance may become so prevalent as to ensure its own corrective."

But the hope of the *Railway Times* was not realized. On the contrary, not only has the practice of "splitting" spread, but it has also developed into the widespread "stock-watering" which was not even thought of at the time when Parliament first gave its permission to stock splitting. A comparison of the following clauses of a railway bill passed in 1890[52] with the part of the Regulation of Railways act, 1868, quoted above, may serve to show the vast difference between the regulations governing "splitting" as adopted in 1868 and the degenerated practice which took place afterwards. The second clause of the Bill of London and South-Western Railway passed in 1890 provides:

The company would create ordinary stock of two classes,—(1) preferred 4% ordinary stock, and (2) deferred duplicate ordinary stock, both classes

[47] He probably referred to the Royal Commission on Railways, 1867.

[48] Hansard, 193: 1545.

[49] Hansard, 193: 1549.

[50] In the Model Bills and Clauses of the House of Lords, 1909, eight clauses (pp. 24-25) were devoted to the regulations governing the division of stocks.

[51] *Railway Times*, August 8, 1868, p. 819.

[52] *Railway Times*, May 17, 1890.

of which to be in substitution of a corresponding amount of paid-up ordinary stock; that is to say, £100 of the preferred and £100 of the deferred ordinary stock should be substituted for every £100 of the existing ordinary stock.

But, it may be remembered, what was permitted in 1868 was a mere "splitting," — "preferred and deferred ordinary stock shall be issued only in substitution of equal amounts of paid-up ordinary stock," while the later practice was actually "duplication," wherewith stock certificates bearing a face value of £200 were given for every £100 paid in.

The chief reason which led the companies to indulge in stock splitting was that they thought the divided stocks would command higher prices than the solid property. But the *Railway Times* both in 1868 and 1891, the years in which stock splitting began and reached its highest point of development, respectively, have proven by the market quotations of the two kinds of stocks of several companies that the expectation of the companies was by no means well founded in many cases.[53] On the other hand, the same paper [54] showed that much confusion resulted from the splitting of stocks. Investors were in many instances led to take up one section of these divided stocks under the delusion that the deferred portion (as in the case of the Great Northern, the originator of the scheme, just referred to) had been previously paid up. As this was far from being the true state of affairs in many instances, much disappointment and suspicion arose. Therefore, Parliament was blamed for being too ready to comply with "every request made to it by speculators in the most desperate condition." [55]

In England it has been held from the beginning of railway legislation [56] that it is not the legitimate business of a railway company to apply to one purpose the funds which have been raised for another and that it was the duty of railway companies to keep up the value of their capital assets — no dividends may be paid out of capital.[57] In the early railway acts

[53] See *Railway Times* for November 14, and November 28, 1868, and May 23, 1891, p. 606.

[54] *Railway Times*, May 2, 1868.

[55] *Ibid.*

[56] See *Report of Committee on Railway Companies Powers*, 1864, p. 58.

[57] Section CLXX of the Croydon act of 1837 provided "That all the money to be raised by the said company by virtue of this Act shall be laid

of incorporation provisions were made as to the purpose for which the company was incorporated and the proper mode of applying the capital raised. Thus in the first Companies Clauses Act[58] a specific provision was made to the effect that all the money raised by the company should be applied, first, in paying the costs and expenses incident thereto, and, second, in carrying the purposes of the company into execution. It was further provided by that act that, unless expressly provided to the contrary, companies might receive and apply to the purpose of the company any calls to be made, notwithstanding mortgages.[59]

Thus both the private and the public general acts required that the company should first of all apply its capital to the payment of expenses already incurred for forming the company, and then to the execution of the purpose for which the company was incorporated.

The financial difficulties and pressure for capital caused by the extravagant extension of railways during the forties led to considerable violation of the foregoing provisions. Therefore the Lords' committee of 1849 was instructed to devise means to guard against the application of funds to any other purpose than those authorized by Parliament. This committee recommended that railway companies should be required to explain in their capital accounts not only how money was raised but the undertakings to which it was applicable and the manner in which it was actually spent.[60]

During the latter part of the fifties and the first part of the sixties, in many railway bills for constructing new works, provisions were not made for raising additional capital; but the companies were permitted to apply to the new works any money

out and applied, in the first place, in paying and discharging all costs and expenses of applying for, obtaining, and passing this Act, or preparatory or relating thereto, incurred; . . . and the remainder of such money shall be applied in and towards purchasing lands, and making and maintaining the said railway and other works, and in otherwise carrying this Act into execution; and that the expenses incurred by the several provisional committees or boards of directors for the said . . . lines . . . shall be raised and paid by the subscribers to the said several lines . . . in proportion to the amount of their respective subscriptions. . .''

[58] 8 V. c. 16, s. 65.

[59] 8 V. c. 16, s. 43.

[60] *Report of Royal Commission on Railways*, 1867, p. xviii.

which they might have been authorized to raise by previous acts and which might not be required for the purposes for which the money was originally raised. In order to protect the shareholders from the danger that might arise from the application of the funds of railway companies to purposes not sanctioned by Parliament and not in contemplation at the time when their powers were obtained, both Parliament and the Board of Trade thought that it was very important to take advantage of every suitable opportunity to ascertain and limit the amount of money that might be raised and to define clearly its application.[61] Moreover, the Board of Trade emphasized this point for several years successively beginning 1859.[62]

When the Companies Clauses Act of 1863 was passed, a clause was devoted to specifying the application of money raised by the issue of debenture stocks, thus giving effect to the recommendation of the Board of Trade.[63] It enacted that money raised by debenture stock should be applied exclusively either in paying off money due by the company on mortgage or bond, or else for the purposes to which the same money would be applicable if it were raised on mortgage or bond.

In the Railway Construction Facilities Act of the following year,[64] provision was again made to the effect that railway companies "shall apply every part of the money raised only for purposes for which it is by the certificate (of the Board of Trade) authorized to be applied."

In practice, however, there seemed to be considerable violation of these rules, especially by the smaller lines. A striking example may be found in the case of the Brecon and Merthyr Railway Company. After having repeatedly violated the law in raising its capital,[65] this company authorized the issue of £20,000 for the

[61] *Board of Trade annual report on Railway Bills*, 1860, p. 22.

[62] *Ibid.*, 1863, p. 19.

[63] 26 & 27 V. c. 118, sec. 32.

[64] 27 & 28 V. c. 21, sub-secs. (4) and (5) of sec. 29.

[65] This railway about 66 miles long was originally contracted to be constructed by a certain Savin at £10,000 per mile; but act after act had since been obtained by its directors and the contractor for increasing the capital, until, instead of the original authorized capital of £700,000, the shares and debentures issued to the contractor for its construction amounted to £2,000,000. In this amount there were no less than ten kinds of preference shares, each ranking in order of date, and fourteen issues of debentures

construction of, and with a special hypothecation on, a branch called the Ivor & Dowlais, which latter was authorized in 1865 but not yet commenced in 1867. It was also found that the act of 1865 had already authorized the creation for the construction of this line, of shares and debentures to the amount of £20,000 and had specially provided that the money should only be applied of this line of shares and debentures to the amount of £20,000 and had actually been issued under the name and were then existing; but that the money was not applied to the line, which was left entirely untouched.

Moreover, this kind of irregularities seemed to have continued for some time. Thus in 1869 a complaint, which had many parallels in railway affairs, was made against the Caledonian Railway by the Forth and Clyde Navigation Company, with whose undertaking and many others the Caledonian had amalgamated. The charge was that the absorbing company had applied the money raised under the special borrowing powers of the particular undertaking to general purposes, to the amount of more than £100,000, in breach of an engagement with the absorbed company. In this connection, the *Economist* said[66] that in many cases even where there was not any apparent objection, the public had been "not a little injured" through the diversion of the borrowing powers conferred. It further said that "if the Legislature lays down rules . . . in order to secure the proper execution of undertakings which it authorized and which it has a claim to see executed by virtue of the privileges conferred . . . care should be taken to have the rules put in force, and a breach of them . . . ought to be rendered impossible."

Another form in which capital has been applied to purposes other than those authorized by Parliament is the payment of dividend out of capital. This practice has been prohibited since the early thirties. Thus in the Croydon Act of 1837 the pro-

also ranking in order of creation. Then the company again obtained from the Board of Trade, under the general Railway Act, 1864, and without any sanction for new lines, powers to create £570,000 of fresh preference stock and £190,000 of fresh debentures stock for which they could not find any market. See London *Times*, November 13, 1867, p. 4.

[66] *Economist*, November 6, 1869.

vision was made [67] to the effect that no dividend should be made exceeding the net amount of clear profit at the time being in the hands of the company, nor whereby the capital of the said company should in any degree be reduced.

During the forties there seemed to be a need for a relaxation of these restrictions. During that period many railway companies received their capital by instalments and had to pay interest pending construction.[68] When calls were made at a time when a high rate of interest could be obtained the subscribers were unwilling to meet such calls. "To obviate this difficulty" it was suggested that "it was not unreasonable for railway companies to resort to the unbusiness-like practice of allowing interest [69] on calls before a railway is opened, and consequently before it has any revenue. The interest was therefore charged to capital, and served to swell the capital expenditures." [70] It must be stated that in some cases the payment of such "interest" out of capital during construction appeared necessary, for in such cases it was "utterly ridiculous to hope for the payment of deposits unless interest be allowed upon them during the construction of the line. Men cannot afford to lock up their capital in a total sacrifice of present results for the chance of any future proceeds, however abundant." [71] In still other cases, the practice was known as being advantageous to all concerned.

On the whole, however, it seemed that the payment of dividends out of capital was not desirable. It was well known as Lord Somerset pointed out [72] that many companies had gone on paying dividends out of their capital stock, as if they were in a most flourishing condition. These companies sometimes went on paying dividends out of their capital until their capital no longer existed.

Under such circumstances, Parliament saw fit to insert a clause in the Companies Clauses Act, 1845,[73] stipulating that "the com-

[67] 1 V. c. cxix, s. CXCIII.
[68] Hansard, 78: 48.
[69] Interest here is used really in the sense of dividend.
[70] *Railway Times*, April 27, 1844.
[71] *Ibid.*, July 25, 1846.
[72] Hansard, 78: 48-49.
[73] 8 V. c. 16, s. 121.

pany shall not make any dividend whereby their capital stock will be in any degree reduced."

The general interpretation given to this clause, as shown by the debate in Parliament, was that it was not to prohibit the payment of dividends from the interest of capital or pending construction, but to prevent the payment of dividends out of the capital stock after the works were completed and when no profits had been obtained.[74]

In 1847 after the panic which followed the great railway extension of 1845, a standing order was passed by the House of Lords which remained in force for many years, providing that in every railway bill a clause should be inserted prohibiting the payment of interest out of capital.[75]

The Companies Act, 1862,[76] also provided in the first schedule that no dividend should be paid except out of profits earned. But this latter regulation was not compulsory on the companies registered under that act, for they were empowered by section 14 to make rules of association excluding the regulations in the first schedule, and were thus practically enabled to make what regulations seemed best to the shareholders. Consequently a curious anomaly arose out of the conflict between the standing order and the Companies Act, 1862.[77]

In the Railway Construction Facilities Act, 1864,[78] provisions were again made prohibiting the application of capital for the purpose of paying interest or dividend on account of calls made. In 1867 a clause was inserted in the Railway Companies Act of that year[79] which prescribed in detail the conditions under which a railway might declare any dividend. It said that no dividend should be declared by a company until the auditors had certified that the current half yearly accounts contained a full and true statement of the financial condition of the company, and that all proper expenses had been deducted from revenue.

But the act further provided that "if the directors differ from the judgment of the auditors with respect to the payment of any

[74] Hansard, 78: 48.
[75] *Railway Times*, March 16, 1889.
[76] 25 & 26 V. c. 89.
[77] *Report of select committee*, 1882, p. iii.
[78] 27 & 28 V. c. 121, sub-sec. (3) of s. 29.
[79] 30 & 31, V. c. 129, s. 30.

such expenses out of the revenue of the half year, such difference shall, if the directors desire it, be stated in the report to the shareholders, and the company in general meeting may decide thereon, subject to all the provisions of the law then existing, and such decision shall, for the purpose of the dividend, be final and binding." Taking advantage of this last proviso, many railway companies, like the Brighton,[80] charged large sums to their capital account, in opposition to the opinion of the accountants and auditors that the same should have been charged to revenue. After violating the law in this manner, they would then legalize their illegal act by calling a general meeting of the company and abide by the decision of the meeting which according to the law should be "final and binding." [81]

One of the chief reasons which led to the evasion of the law was that, as a member of Parliament remarked in 1867, "There is nowhere to be found a clear definition of working expenses, that is to say there is nothing to define the charges which ought to go to make up the working expenses of a company, before you arrive at the profit upon which the debenture interest forms the first charge." [82] The government itself was said to be unable to distinguish working expenses from capital charges. When once it was asked to define and determine what constituted the profits of a railway, the Board of Trade appointed a committee to consider the matter. This departmental committee reported, however, that "it was too complex and difficult a matter for them to undertake, and they recommended that the question be referred to a small body of experts specially appointed for the purpose. The Board of Trade was consequently asked to appoint such a committee, but it declined to do it.[83]

Under such circumstances, it became an easy matter for railways to disregard all principles of accounting, if they saw fit. The gross income representing the returns from which the working expenses must be deducted before any money should be used for dividends, was a definite quantity and could not be meddled with; but the working expenses were not, and might be "switched." So some of the railway directors, in order to make

[80] London *Times*, November 18, 1867, p. 8.
[81] See Fraser, *British Railways*, 1903, p. 117.
[82] Hansard, 186: 1030.
[83] Fraser, *British Railways*, 1903, pp. 52-53.

their business appear "rosy," often charged part of such working expenses to capital and declared dividends out of capital.[84]

Moreover, the matter of charging certain items of current expenses, such as the purchase of engines, etc., to capital was viewed with more or less approval by the shareholders. In some cases it was not considered at all improper or injurious, still less dishonest, to defray a portion of the current expenditure out of money borrowed, and treat as net income or profit what then appeared as the remainder. These shareholders even would often exact dividends whether earned or not, and would connive at the means so long as the immediate end was secured. A decent dividend not only enriched their pockets, but kept up the market value of their shares. Five per cent in hand, with their holdings at par, even temporarily, appeared far more comfortable than three per cent with the stock at a discount, in spite of promising hopes. Therefore, accounts were "cooked" on the one hand and "swallowed" on the other.[85]

In 1882 an open effort was made to remove the restrictions prohibiting the payment of dividend out of capital.[86] A committee was appointed by Parliament to consider the matter. This committee, after six sessions and a month's work, reported [87] that the prohibition of the payment of interest out of capital was in accordance with "sound financial principles and acts as a protection to the public." In special cases, however, the committee recommended that it might be permissible, subject to strict rules,[88] to pay interest upon capital during construction.

[84] London *Times*, October 29, 1867, p. 6.

[85] London *Times*, November 18, 1867, p. 8.

[86] *Railway Times*, March 16, 1889, p. 374.

[87] See Report of Select Committee, 1882, *Parliamentary Paper*, 1882, vol. 13, p. iii.

[88] The rules recommended were briefly:

(1) Clauses defining the amount of interest, and the terms for which it is payable, to be inserted in every bill, and to be specially reported on by the Board of Trade before being submitted to the committee (on Railway Bills).

(2) Such interest to be an addition to the authorized capital of the undertaking.

(3) Power of issuing debentures to be reckoned on the capital exclusive of such addition for interest.

(4) Payment of such interest to continue only during construction of

Although the effort of the railway companies was unsuccessful, it brought about much agitation, as a result of which the House of Lords in 1886 modified its standing order so as to give power to railway companies, under certain strict provisions, to pay interest out of capital.[89]

The relaxation of the earlier regulations, however, was not accompanied with such good results as was expected.[90] On the contrary, much evil was done. The effect of paying interest out of capital, as observed a writer,[91] has been to give a certain particular stock an altogether fictitious value, and genuine investors have been victimized. The same writer also alleged, not without reason, that the dividing up of principal money as profits and the lack of restraint as to their enormous expansion of capital expenditure, regardless of its productivity of revenue, can, and did, only eventuate in a diminution, or even entire cessation, of dividends on ordinary stocks.[92]

The result of charging working expenses to capital has proved to be equally objectionable. It necessitated the overburdening of the business with large capital charges, which sooner or later would give much embarrassment to the property.[93] In so far as the public was not clearly aware of these manipulations, the practice proved exceedingly illusory. It was merely a matter of white-washing the true state of affairs by throwing expenses on the revenue of the future. Indeed, the besetting evil of railway finance, as observed the London *Times*,[94] "has arisen from the

the works, or for such less period as the committee may think fit to authorize, according to the circumstances of the case.

(5) The rate of interest to be fixed by the committee, but in no case to exceed 5 per cent.

(6) The prospectus and share certificates to contain on the face of them an intimation that interest is payable out of capital during construction only.

The committee also recommended that these provisions should be enacted in a general act, instead of mere modifications of the standing orders. See Report of Select Committee, May 19, 1882, *Parliamentary Paper*, 1882, vol. 13.

[89] *Railway Times*, March 16, 1889, p. 373.

[90] *Ibid.*

[91] Fraser, *British Railways*, 1903, pp. 108-109.

[92] *Ibid.*, p. 144.

[93] London *Times*, November 18, 1867, p. 8.

[94] *Ibid.*, October 29, 1867, p. 6.

confusion of two things — capital and revenue.'' Some of the most serious disputes, which affected in a remarkable degree the property of some important companies, turned entirely upon the mystification over the charging of these two items. Directors were charged with carrying to capital, expenses which belonged to revenue; and proprietors demanded that capital accounts should be closed. The general effect was that fictitious dividends made it almost impossible to estimate the value of any railway property.

From the foregoing pages, it is clear that most of the regulations governing the share capital of railway companies were adopted prior to 1845. It is only in a very few instances where any changes have been made after the passage of the Companies Clauses Consolidation Act of 1845. But these changes, although few in number, have proven of great importance as well as of a unique nature. Indeed, it is largely in the adoption of her regulations since 1845 concerning such matters as the creation of preferred and deferred stocks and the application of capital that England especially differed from other countries.

A special feature revealed is the fact that practically all the measures concerning the share capital of railway companies, as we have seen, were adopted as a matter of course. With the exception of those concerning stock splitting and the application of capital practically all the rules governing railway share capital were adopted without any debate in Parliament. Nor did they receive much discussion from the public. This, however, is not the case concerning the regulation of the other branches of railway finance as we shall see in the following chapters.

CHAPTER III

SUPERVISION OF RAILWAY CAPITALIZATION

B — LOAN CAPITAL

In the earlier years of the English railways, loan capital consisted of mortgages or bonds, which were commonly called debentures, and which resembled the bonds issued in the United States. In later years a class of securities called debenture-stock came into vogue. The debenture-stocks were similar to the debentures in that each of them represented a debt with a fixed rate of interest against the company. They were, however, distinctly different in two respects. First, the debentures were usually issued for limited periods, while the debenture-stocks were usually perpetual; and second, the former were represented by deeds issued by the company to cover large lump sums of money, whereas the latter were issued in the form of circulating certificates, in coupon form, to represent smaller amounts. Debenture stocks, however, were little known until the fifties. Accordingly, Parliamentary regulations applied at first to the temporary debentures or mortgages, but were gradually modified to take care of the permanent debenture-stock.

The cardinal policy of Parliament, as a member of Parliament said,[1] to which opinion he subscribed, has been to make the debenture capital of railways a secure investment. With this goal in view, Parliament has endeavored to regulate the loan capital of railways from the beginning of the enterprise. In each of the special acts, which created the company or enabled it to prosecute its work, the amount of the loan capital as well as the manner in which the company might raise it were invariably set forth in detail. Aside from some occasional and slight irregularities, the proportion of the loan capital was usually limited to one-third of the share capital of each company.[2] This was done

[1] Hansard, vol. 183, p. 785.

[2] Cf. *infra*, Chap. IV.

to give security to the debentures or mortgages. Before a company could raise any additional capital by loans or in any way alter the provisions of its incorporation act it was required to appear before Parliament for a special act granting such power. Thus from the beginning railway companies were subjected to explicit regulations set forth in their special acts in raising money by loans. The following passage from the London and Croydon Railway Act of 1837 [3] may serve to illustrate how and under what conditions railway companies were permitted to raise money by loans:

> And be it further enacted, that it shall be lawful for the said company, by an order of any general or special general meeting of the said company, after one-half of the said capital shall have been paid up, from time to time to borrow and take up at interest any sum in addition to their said capital of one million eight hundred thousand pounds, not exceeding in the whole the sum of six hundred thousand pounds, on the credit of the said undertaking, as to them shall seem proper; and the said company and directors . . . after an order shall have been made for that purpose at any general or special general meeting . . . hereby empowered to mortgage, assign, and charge the property of the said undertaking, and the rates, tolls, and other sums arising or to arise by virtue of this Act, or any part thereof, . . . as a security for any such money to be borrowed as aforesaid, with interest; . . . and a copy of the order of any general or special general meeting . . . authorizing the borrowing of any such sum of money, certified by one director or by the secretary or clerk of the said company to be a true copy, shall be sufficient evidence of the making of the order; . . . and all which mortgages, assignments, and charges shall be made under the common seal of the said company by deed duly stamped, in which the consideration for the same shall be truly stated. . .

The forms to be used for such mortgages as well as for the transfer of the same were prescribed. Provisions for the registration of the execution and the transfer of such securities were also set forth in detail.[4]

For the security of the creditors, section CLXI of the same act provided that in case of non-payment of interest as specified in the act, by an order of two justices of the peace, "some person may be appointed to receive the whole or such part of the said rates, tolls, or sums as are liable to pay such interest so due and unpaid. . ."

The time for repayment of the principal was required to be

[3] 1 V. c. CXIX, sec. CLX.

[4] *Cf. infra*, Chap. V.

clearly specified in the mortgage deed,[5] and if no time was specified, the holders of such mortgages might demand payment after twelve months from the date when the loan was made, "upon giving six calendar months' notice in writing to the secretary or clerk of the company. . ."[6] If the company failed to meet such demand of repayment of the principal due and if such principal in the aggregate amounted to the sum of £20,000, two justices might order the appointment of receivers[7] as in the case of non-payment of interest.

From these provisions, it is clear that besides the limitations upon the borrowing powers of railway companies, two distinct principles were laid down, (1) the real security of the mortgages was limited to the "undertaking,"[8] the tolls and rates of the company, and (2) these mortgages were for limited periods, and were liquidated or renewed upon the expiration of such periods. Both of these principles, as will be shown more fully, gave rise to much difficulty afterwards, the one on account of its own defect which was not foreseen at the time and the other because of the wrong conception of it by the public.

These special provisions regarding loan capital soon became too numerous and hence difficult for the railways to follow. Under such circumstances, it was but natural that many irregularities took place in making loans, notwithstanding the intention of Parliament to prevent them. To simplify matters, Parliament devoted no less than twenty sections of its first Companies Clauses Act[9] to regulations governing loan capital of railways. In this general act, the miscellaneous provisions scattered in the numerous special acts governing the limit of borrowings, the registration of mortgages and transfers, the appointment of receivers, etc., were amplified and set forth in a compact form. The forms of mortgages and transfers contained in the special acts were also improved upon by making the provisions more specific and more adaptable to the new conditions. The powers of re-borrowing and of conversion of loans into share capital were also amplified. But the most notable change was that re-

[5] Sec. CLXIII.
[6] Sec. CLXIV.
[7] Sec. CLXV.
[8] By undertaking was meant the business of the Company.
[9] Companies Clauses Act, 1845, 8 V. c. 16.

garding the evidence of authority for borrowing. Formerly, as seen in the Croydon Act, nothing was required to show that the company had complied with the requirements set forth in its private acts as to the requisite subscription and payment of one-half of its capital, etc., before borrowing. The only evidence necessary was a copy of an order of a general meeting certified by a director, or the secretary, or even the clerk of the company. By the general act of 1845, however, a new provision [10] was made to the effect that in addition to such a certified copy of an order of a general meeting, a certificate of a justice of the peace showing that the definite portion of the company's capital, stipulated in its special act, had been subscribed and paid up, should be presented before a company made any loans. Thus the financial affairs were placed, to a certain extent, under the supervision of a public officer.

In examining these clauses of the act one cannot help being impressed with the great care which Parliament took in order to make the loan capital of railways a safe investment. Indeed, if these provisions had been conscientiously followed they might have proved effectual to carry out the intentions of Parliament and to prevent much difficulty which occurred later.

It must be remembered that the aforesaid general act was passed during a period of railway speculation. This and its subsequent collapse, which took place two years later, furnished a good test of the usefulness of the provisions concerning finance just referred to. Up to 1848 about £175,000,000 had been invested in railways, of which about £40,000,000, or one-fourth, was raised by loans. On account of the collapse of 1847, exorbitant rates of interest had to be offered; and notwithstanding such inducements, some of the best lines could not be completed for want of funds.[11] During the collapse, railway credit was greatly damaged. Whatever loans were made, were only for short periods. In order to clear off the wreckage of 1847, Parliament in 1850 passed the Abandonment of Railways Act [12] "to facilitate the abandonment of railways and the dissolution of railway companies. . ." This act provided that the com-

[10] Companies Clauses Act, 1845 (8 V. c. 16), sec. 40.

[11] C. L. Webb, *Letter to H. Labouchere, Board of Trade, on Railways*, 1849, p. 26.

[12] 13 & 14 V. c. 83.

panies' share as well as loan capital should be reduced proportionately with the amount of the work abandoned.[13] Aside from this incidental provision contained in the Abandonment Act of 1850, nothing was done to alter the rules laid down in the Companies Clauses Act of 1845 during the period. Even the derangements caused by the crisis of 1847 failed to induce Parliament to adopt any new or to modify its old measures. But beginning about 1850 complaints against the existing system of loans began to be made by numbers of investors. As the debentures issued under the existing system were by deed for large lump sums, people with money to invest were debarred from placing it in such debentures because they could seldom find such as would suit them in amount and length of time to run. Some companies also expressed dissatisfaction with the inconvenience and expense attending the existing system of arranging their debenture debts.[14] It was felt that the securities for money lent to railway companies should be issued for more convenient amounts and that they should also be made easier of transference. Therefore, it was urged that divisible debenture stocks be issued and the existing system of stamps and registration remodeled. But it was at once recognized that it would be difficult to get rid of the stamps, since the government would not forego its revenue from this source. To meet this difficulty, a proposal was made that the government should not be stripped of its tax, but only it should receive it in a different way. In lieu of the existing system of stamps, each company should pay a fixed annual sum to the government, calculated on an average of, say the preceding three or four years, or in some other way satisfactory to both parties. Then the debenture stock certificates might be issued without stamps and passed from hand to hand without registration. In support of this system, besides other arguments, the success accompanying a corresponding change in the East India Company's bonds, made under similar conditions, was cited.[15]

To do away with registration would apparently save some

[13] Sec. 28, 13 & 14 V. c. 83.

[14] *Railway Times*, Dec. 31, 1853, p. 1354.

[15] The bonds of the East India Company were once stamped, but in 1835 the company obtained powers under the Act 5 & 6 Wm. c. 64 to pay an annual sum in lieu of stamp duty. *Cf. Railway Times*, Sept. 25, 1852.

trouble; but it was apprehended that such a course might create confusion and also impair the security of the debenture-holders. To avoid such danger, it was proposed: (1) Any company wishing to avail itself of the power of the act should be required to show that, on the average of the preceding three years, its net annual profit had been equal to 10% on its debt; (2) the amount of the debt should in no case be increased after the application to Parliament for adoption of the act; (3) that such company should be bound, under penalty, to publish quarterly in the London *Gazette*, a statement showing the amount of its debt, the sum required for payment of the quarter's interest on the same and the actual amount of net profit earned during the same quarter. It was thought that, with these particulars before them, the public could at once detect any irregularities in a company's loan capital, and that in the absence of any irregularities, a profit equal to 10% of its loan capital would constitute a sufficient security to the company's debenture holders.

The division of debentures into convenient units representing £100 to £1,000 was enthusiastically expected to have an important and beneficial effect. Instead of a person who wished to sell say £5,000 railway debentures having to wait until he could find another person having that exact sum to invest, he would be able to divide the amount among a number of purchasers. By this process, transactions would be greatly facilitated and the market extended. Moreover, when the debt was spread over a great number of persons, it would not be so easy for a combination of large money-lenders to demand repayment of loans at inconvenient times so as to embarrass the company for their own benefit. Thus a great difficulty with which the companies had to contend would disappear.[16]

Following these agitations further efforts were made during the years from 1851 to 1853 to effect an alteration of the existing debentures by the issue of stocks carrying a fixed rate of interest and affording other owners the same privileges as the debentures, in lieu of the existing bonds.[17] Parliament, however, failed to see the necessity of passing any act to accomplish the changes; but self-interest induced a number of companies to convert their debentures into such perpetual debenture

[16] *Railway Times*, Sept. 25, 1852, pp. 100-109.

[17] *Railway Times*, Dec. 31, 1853, p. 1354.

stocks. The innovation was looked at askance. The idea was still rife that loans were only a temporary charge which ought to be gotten rid of as soon as possible. Anything which had to do with perpetuating such loans at once aroused suspicion. In commenting upon such practices, the *Railway Times*[18] said that such operations were "suggestive of grave reflection." It lamented that railway companies should change their debts into a permanent part of their capitalization, and regarded such a change as an unmistakable evil. It urged that those companies which had borrowed to a large extent "would do well to make up their minds to pay off debentures . . . before they partake of any dividends, no matter how moderate or legitimately earned." "Every proprietor who is capable of serious thought, and who desires to leave an unincumbered estate to his children should make it his duty to strive for an extinction of the loan debt of every company with which he is connected. . ." It was the general idea that when a company was out of debt it was out of danger. But it soon became clear that the debts of railways, once contracted, were going to remain. The companies clearly realized the usefulness of these debenture stocks. This class of securities would enable persons who had no speculative desires, who had no enterprising tastes, who had no practical knowledge, to aid in the successful completion of splendid undertakings; they would enable such persons to obtain the single object which they desired — a fixed secure income.[19] But what was of far greater importance was the fact that debenture stocks would save the companies from being swamped by debentures falling due at unfortunate times. This great advantage, however, was not clearly recognized until some years afterwards. It was the need of money which gradually led a number of railway companies to use debenture stocks.

Beginning with the fifties, it became quite general for railway companies to apply to Parliament for powers to create this class of stock for the purpose of paying off mortgages and bonded debts, or as a means of raising money in lieu of borrowing on mortgages or bonds.[20] Therefore, it became important that the legal powers under which the old debentures should be ex-

[18] *Ibid.*, May 8, 1852, p. 473.

[19] *Economist*, May 2, 1863, p. 477.

[20] Board of Trade, *General Report on Shares, Loans, etc.*, 1860, p. 17.

tinguished and the debenture stocks created, should be clearly defined. No general legislation took place. What Parliament did was to insert clauses in the bills of the companies seeking powers to make such conversions of new issues. In these special acts, Parliament prescribed in detail the manner in which such conversions of debentures or the creation of new debenture stocks might be effected. The following passage from the Act of 1851 of the London and Northwestern Railway [21] which was one of the most important companies using this class of securities, may serve to show in what way Parliament legislated on the issue of such stocks:

That it shall be lawful for the company from time to time, with the consent of three-fifths of the votes of the shareholders present in person or by proxy at any general meeting of the company convened with due notice of that object, to resolve that any portion of the borrowed capital of the company, or any debenture or other security for which or for the interest whereof the company are lawfully liable, . . . not exceeding an amount to be defined in and by such resolution, may be converted into stock of the company of like amount, either by agreement with the holders of such mortgages or bonds respectively before the same respectively became due, and issuing stock of a corresponding amount, instead of reborrowing the same so paid off; and also, with the like consent, from time to time, to resolve that the whole or any part, to be defined in and by such resolution, of the moneys which the company shall have authority to raise by borrowing under the powers of any of their Acts, . . . shall or may be raised by the creation and issue of stock of a corresponding amount, instead of borrowing the same; and also, with the like consent, to attach to the stock so authorized to be created and issued for any of the purposes aforesaid a fixed and perpetual irredeemable yearly dividend or interest at any rate not exceeding the rate of £3 10s. for every £100 thereof; . . . and the stock so created and issued shall be a charge upon the tolls and undertaking, and lands, tenements, and hereditaments of the company, but shall be distributable, transmissible, and transferable, . . . and the said interest or dividend shall forever have priority of payment over all other dividends on any other stock or shares of the company, whether ordinary or preference, or guaranteed, and the stock when so created shall be termed "*London and North Western* Debenture stock;" provided that nothing herein contained shall in anywise prejudice or affect the rights of the holders of mortgages or bonds of the company. . .

Four distinct principles were set forth in this clause: (1) Debenture stocks might be issued in redeeming debentures fall-

[21] 15 V. c. cv. Quoted by John Whitehead in his book on *Guaranteed Securities*, 1859, pp. x-xi.

ing due as well as for raising additional loan capital within the company's powers; (2) the rate of interest was fixed with the consent of Parliament; (3) the security of such stock should consist in a charge upon "the tolls and undertaking, and lands, tenements, and hereditaments" of the company; and (4) such stocks were to be "distributable, transmissible, and transferable as personal estate." It must be remembered that some of these principles were not new, but were copied from those governing the issue of the older forms of securities. On close perusal, it may be seen that the provisions contained in the clause were such as to make the debenture stocks a safe and clearly-defined investment. Indeed, Parliament had by this time recognized to a certain extent the necessity of this class of securities for the improvement of the financial condition of the railways, and commenced to take steps to give the holders of debenture stocks every possible protection and security. Thus in the act just referred to provisions were made to the effect that if written demand for the payment of dividend due on any debenture stocks was not met satisfactorily within thirty days, the proprietors of such stocks holding an amount of nominal value of £20,000 or upwards might, without prejudice to their right to sue, require the appointment of a receiver.[22]

By these provisions, the debenture stockholders were given the power to recover the arrears of their interest either by bringing suit in any competent court or by requiring the appointment of receivers. It may be noticed, however, that only the interest was secured, and the principal was not mentioned. There was some dissatisfaction over this fact, but it was generally conceded [23] that so long as the interest was made sure, the principal would take care of itself, for what the average investor wanted was not so much the possession of his principal but a regular and reliable income that grew out of the principal. This was especially true when his security was easily marketable.

The chief reason why Parliament took such precautions to give great security to the holders of debenture stocks was that there was an abundance of money ready for investment and the only thing necessary to induce investors to come forward

[22] 15 V. c. cv. XII.

[23] *Economist*, Feb. 23, 1867.

was indisputable security.[24] With this point in view, Lord Redesdale in 1856, endeavored to insert a clause in the railway bills of that session, making the railway directors personally liable for any illegal issue of debenture stocks; but this proposition, which if adopted might have prevented much trouble, was "killed" in the committee room.[25]

But it must also be noticed that what Parliament did was for the protection of the holders of legal securities. If one's security was legal, he was safe, but no protection was extended to the holders of illegal securities. Parliament prescribed the rules governing the issue of railway securities, and laid down the principle that securities issued in violation of these rules were illegal and hence not within the protection of law. *Per se* this doctrine appeared proper and good. But how were the investors to know which securities were legal and which were not? Parliament gave adequate protection to the holder of legal securities, but it failed to enable the investors to distinguish the legal from the illegal. Hence in spite of the repeated and apparently earnest efforts of Parliament much dissatisfaction existed. Complaint was heard everywhere as to the difficulty of distinguishing the legal from the illegal security.[26]

To determine the legality of a security required an understanding of a number of acts of Parliament which the ordinary investors could hardly construe correctly without a lawyer's aid. Yet if these acts were not justly construed and precisely obeyed the debenture would give no effectual charge upon the line, and hence the holder of it would have no legal claim to priority over even a contracted debtor of the company. Furthermore, the nature of the law was such that a debenture which was once bad would remain bad. A debenture which was invalid at its issue because it was in excess of the borrowing powers, would not be improved because other debentures were paid off. The contract was illegal when it was executed, and it could not gather legality by subsequent payments to third parties.[27]

[24] *Railway Times*, Aug. 4, 1855, p. 781.

[25] *Ibid.*, April 26, 1856, p. 514.

[26] It was often heard in bank parlors, "How do we know this debenture is worth anything? The validity depends on its accordance with the borrowing powers of the company, and what those powers are, or how they have been exercised, we do not know." Compare *Economist*, July 11, 1863.

[27] *Economist*, May 2, 1863.

In spite of this unsatisfactory state of affairs, the use of debenture stocks continued to become more extensive. To insure uniformity in practice and to facilitate the use of such stocks, the Board of Trade repeatedly recommended,[28] during the latter part of the fifties, that provisions should be made in a general act embodying the principles governing the issue of such stocks. Consequently Parliament in 1863 codified into general law the various provisions scattered in the special acts as well as some of the recommendations of the Board of Trade. A large part of the Companies Clauses Act of that year[29] was devoted to the regulation of debenture stocks. Provisions were made as to the creation and issue of debenture stocks, the priority of such securities, the limit of the rate of interest and the enforcement of payment of such interest either by action or by the appointment of receivers. The companies were also required to keep a register of debenture stocks issued and to deliver certificates to holders of debenture stocks, etc. In short practically all the provisions contained in this act governing the creation and issue of debenture stock were modelled after those governing the creation and issue of the earlier forms of securities, and which had been heretofore inserted in special acts.

The improvement, however, was not enough to meet the situation. The act provided, in great detail, for the regulation of the debenture stock itself, but it did not afford any effective means for the enforcement of the regulations. It gave further protection to the holders of legal debentures; but it again failed to evolve any means by which one might be enabled to tell which debenture was a legal one and which was not. In brief, it stopped short at the point where action was demanded. Hence, in spite of the act, little improvement was made to clarify the doubt which prevailed. In the meantime gross encroachments upon the acts of Parliament were made.

Being at a loss as to how to mend the situation, Parliament appointed a select committee in 1863 to inquire as to what should be done to prevent such encroachments;[30] and the work of this committee was continued by another select committee appointed in the following year. Both of these committees

[28] Board of Trade, *General Report on Railway Bills*, 1861, p. 23.

[29] 26 & 27 V. c. 118, Part III.

[30] *Cf. infra*, Chap. IV.

were of the opinion that holders of statutory debentures duly registered, should have a right to recover and secure the payment of all principal and interest due to them in priority to the holders of other obligations not issued under the authority of Parliament.[31] They also recommended that the right of the public to the use of the railways should be protected and that the rolling stock and plant of a railway should never be seized by creditors. Moreover, the committee recognized the evil resulting from the lack of means to establish the legality of debentures. Therefore it was also urged [32] as a modified protection to the holders of such debentures that there should be a semi-annual declaration in the gazette of the state of the borrowing powers of the company and an endorsement upon each certificate. This was not expected to render it impossible for the companies to issue debentures beyond their borrowing powers; but it was hoped that the knowledge of the fact that their misconduct would be palpably and continually kept before their own eyes, would be a powerful force in restraining the directors from exceeding such borrowing powers to any considerable extent. Many plans [33] for verifying the legality of debentures were proposed, of which one advocated that there should be an examination of the debenture accounts by a public department, and that a stamp should be affixed to the debenture whose legality had been ascertained. It was also urged that the chairman and secretary of the railway company should be required to certify under their hands the amount of debentures at any time issued, and should be made liable to penalty if the amount was false, or if the debentures issued were in excess of their borrowing powers. The great weakness with a scheme like that was that it did not provide for the most common case in which debentures were issued by mistake. As the directors were liable in almost all cases under such a scheme except that of mistake, it was readily recognized that such a scheme would not prove very effective.

It was also proposed that all debentures illegally issued should be made binding on the company and have a claim prior to the dividends of the shareholders. This was based on the usual as-

[31] Select Committee of 1864, *Report*, pp. III-IV.

[32] Evidence before select committee of 1864, p. 27.

[33] *Economist*, July 11, 1863.

sumption that the shareholders appointed the directors who managed the business and should, therefore, be liable for their misconduct. But it was recognized that "considering how little real influence most shareholders, in fact, have in the appointment of the directors, it appeared rather hard to reduce their dividends if the directors are dishonest. . ."[34]

Parliament, however, was not ready to adopt any of these propositions. So the situation drifted from bad to worse. The goodness of debentures and the repayment of the money borrowed, as in the case of the Great Eastern,[35] became the subject of a complicated controversy even between the directors and the deputy chairman of the company. The one would say that bad securities had been issued, while the other would deny the charge; and the world had to judge between them. In some cases debentures were issued when no real capital whatever had been subscribed. As in the case of the Eastern Section Railway,[36] certain "receipts" were exchanged between a financial agent and the company by which transaction "apparent capital" was created. Thus the parliamentary requirements and restrictions were utterly disregarded. But this case was not the worst. Some men who were known to have "the greatest repute for integrity and the highest standing," went so far as to "pawn" debentures not only in an illegal manner, but even for fraudulent purposes. As revealed in the case of the London, Chatham and Dover Railway,[37] supposedly genuine debentures issued by the company were found later to have "nothing in them." In defence of the company, one of its directors declared that those "debentures were not debentures at all." He admitted that he had obtained money on them, but he said "They were not worth anything." They were "quasi things" and the good securities were elsewhere. It was no wonder, therefore, that the whole basis of railway credit was utterly shaken.

To make things still worse, the treacherous instrument called Lloyd's bonds[38] also appeared in the financial market about

[34] *Economist*, July 11, 1863.
[35] *Economist*, Aug. 12, 1865, p. 970.
[36] *Economist*, Oct. 27, 1866.
[37] *Economist*, Oct. 27, 1866.
[38] For a description of these bonds *cf. supra*, p. 19.

this period. What followed was but natural. Distrust and dissatisfaction over railway securities was felt everywhere. It was urged that the government should see to it that the law was complied with. A loud cry [39] was also raised demanding that government should stamp all the debentures issued as it stamped money and "ascertained the qualities of schoolmasters," [40] so that only the allowed number would be permitted to circulate.

Nothing, however, was done by Parliament to meet the demands. In the meanwhile the railway panic of 1865-1867, which was the result as well as the cause of the growing distrust in railway debentures, was setting in, during which a number of companies suffered great embarrassments. The credit of some railway companies like that of the South Eastern was greatly injured on account of the pressure brought about by the renewal of their debentures. Other companies, like the London, Chatham and Dover, met with "utter and disgraceful failure" [41] due to similar causes. What was even of greater consequence was the effect of such happenings upon the credit of the whole railway system. The accidental circumstances of mere neighborhood to the "exploded" companies was construed into some participation in their faults. In the midst of this chaos, a royal commission was appointed to examine the whole matter, with a view toward government purchase as a solution of the problem. Parliament intended to postpone all action until the commission had finished its work; but the prevailing difficulties made early action necessary. Therefore, in 1866 the Railway Companies Securities Act [42] was passed for the purpose of remedying the situation.

By 1867 the panic subsided; but the old ominous controversy over the nature and value of railway securities was still rife. In fact it held all other financial matters in abeyance. Of the aggregate railway capital of about £450,000,000 more than 27% represented debenture debts,[43] the number of investors in such securities numbered no less than 100,000.[44]

[39] *Economist*, Nov. 17, 1866.
[40] *Ibid.*, Oct. 27, 1866.
[41] *Ibid.*, 1866, pp. 1484-1485.
[42] 29 & 30, V. c. 108. *Cf. infra*, Chap. V.
[43] London *Times*, Feb. 6, 1867, p. 9.
[44] Hansard, 185: 297.

Meanwhile the current belief was that a man lending money upon a debenture, lent it upon a mortgage not only of the income, but also of the property of a railway company. But this belief was shattered by the decision of the Lord Justice in the London, Chatham and Dover Company's land case,[45] in which the principle governing the question was laid down at some length. It was held that the holders of railway debentures were not only without any immediate hold on the general property of the undertaking as distinguished from its income, but were not entitled to any claim to the rents or proceeds from the sale of the company's surplus land. In other words, the debenture-holders had only a hold on the tolls and earnings of the line and not on the property of the company. The whole question seemed to have turned on the interpretation given to the word "undertaking" in the security which the debenture-holders received for their money. The popular idea was that by that term the debenture-holders were mortgagees of the whole property and effects of the company. But the court held that the object and intentions of the legislature were to create a railway "which was to be made and maintained, by which tolls and profits were to be earned, and which was to be worked and managed by a certain company. . ." "The whole of this when in operation is the word contemplated by the Legislature, and it is to this that the name undertaking is given."

This decision and the financial depression of 1865-1867 brought to light the following broad and practical points regarding railway debentures.[46]

First. The Court of Chancery would not undertake to manage a railway for the debenture holders. It was true that in

[45] During those years many companies acquired, either accidentally or involuntarily, more land than they ultimately needed, and such lands sooner or later were resold, so that the proceeds might revert to the capital of the concern. The London, Chatham and Dover more than other companies, had a considerable amount of such lands which was valued at about £1,000,000. The debenture-holders, naturally enough, desired to establish their claims upon this as well as other properties of the company, and applied to the Court of Chancery for a receiver to take and hold for their benefit the proceeds from the disposal of such lands when sold and the rents in the meantime. It was on this claim that the decision referred to in the text was rendered. *Cf.* London *Times*, February 6, 1867, p. 9.

[46] *Economist*, Feb. 2, 1867.

some cases the Court of Chancery did, for limited periods, undertake the management of large concerns; but this was done with the view of winding up that concern. But it could not wind up a railway. A railway was, as had been recognized then, an unending business and the court could not wind it up.

Second. The debenture-holders could hardly manage the railway in case their interest and principal were in arrear, even if they wanted to do so. They were not a corporate body. They could not appoint directors to manage for them. The majority of all but one had no more legal capacity than the one.

Third. The debenture-holders had not even a preferential claim or mortgage on any outlying surplus land.

Fourth. The debenture-holders could not *sell* the railway. The right of building the railway was given by Parliament to a certain specific company. Neither that company, nor any law court could sell it save by the assent of Parliament. "Once a railway company, always a railway company." It was a sort of a consecrated entity, which only Parliament could create, and which only the same body could change.

Fifth. The mortgagees could not split their securities in spite of the Act of 1863, the old form of debentures representing lump-sums of money being still the most common form of securities issued by railway companies. Thus the investors must take the security as a whole and as a unit, and as they found it.

But the real state of affairs was not as objectional as these difficulties would suggest. All but the last of these drawbacks applied only to the poorer roads, which were in difficulty, and did not have any reference to the debentures of strong, solvent companies.

But the most objectionable drawback of the railway debentures was the falling due of such securities at fixed and often unfortunate seasons. This was fairly recognized in the early fifties, but was made clear during the depression. Experience had taught the hitherto credulous that short-period debentures were dangerous and uncontrollable, "a lottery within themselves." Some companies "highest in credit, most secure in revenue . . . unassailable in repute found themselves . . . as helpless as the vilest excrescence which had been able to foist itself into the family of railway interests. . ." Thus the *Railway Times*

urged that short-period debentures be abolished and in place debenture-stocks issued at such a rate of interest as would establish for them an immediate and permanent popularity. The *Economist* also advocated that in the interest of the companies as well as the investors, it was essential that a large portion of the existing 110 millions sterling of debenture bonds which would mature at fixed periods, very often without any or at least with insufficient notice, should be changed into debenture stocks, representable in consols at the option of the holder, by certificate to bearer in coupon form. Some members of Parliament [47] also recognized the evil of the existing system of debentures. Many solvent companies were often placed in considerable embarrassment by the claims of the holders of such short-period debentures. Indeed, to permit a large amount of capital raised with short-period debentures to be sunk in a fixed undertaking was regarded as a great error on the part of Parliament.[48] The legislature was forced to recognize this evil, when borrowers were compelled to come constantly or "almost hourly" before it for renewals of their loans.[49]

Under such conviction, many people firmly believed that permanent debenture-stocks should be created in place of the existing "accommodation bills," as the railway debentures were called. It was urged [50] that this reform would not only save the companies the periodical recurrence of the danger inherent with the falling due of short-period debentures, but would also mean an immediate source of saving in money and trouble to the railways. It would relieve the railways from the trouble of stamping, and would save the commissions and fees to lawyers and brokers as well as the wages of the staff of clerks employed for managing the debenture business. Therefore, new debenture-stocks should be issued to shareholders in place of dividends, and this procedure, it was thought, would prove acceptable to the shareholders.

Another defect of the law which was brought to light by the financial depression, and which led to an enlightened and most

[47] Hansard, 185: 785.
[48] *Ibid.*, 186: 1030.
[49] *Ibid.*
[50] London *Times*, March 23, 1867, p. 12.

beneficial enactment, was the fact that the debenture holders had no preferential claim on the rolling stock which formed the implement of the trade. In the absence of any adequate protection for the rolling stock, even if the debenture-holders did unanimously concur in the management of a railway to compensate their losses in interest or principal, they would still be in danger of having the carriages seized by the contractor, the engine maker, or any other casual creditor of the company. The debenture mortgage was on the "tolls or fares" of the railway, and there was no specific pledge of the carriages.[51] Therefore legislation was needed to keep the railway intact in order to safeguard the security upon which the debenture-holders had a claim, namely: the earnings of the company.

As might have been expected, the panic of 1865 and the resultant discoveries regarding the validity and securities of railway debentures created a widespread alarm among the owners of these securities, which fact in turn involved many railway companies in serious embarrassment. Interest to the amount of one-half to one per cent higher than should have been paid according to the natural state of the money market had to be offered in order to induce investments.[52] It became essential for Parliament to take action in order to remove such alarm. Moreover, the fact that the class of people who invested in such securities were those who needed the greatest protection made immediate action necessary.[53] Early in 1867 the Railway Debenture Holders Bill was introduced to prevent any one class of creditors from injuring the public and other losses of creditors by seizing the rolling stock so as to stop the working of the line.[54] This measure, before being presented to Parliament, was submitted to and approved by "the highest authorities" of the leading railways and was also approved by the Attorney General.[55] What the bill asserted was that the whole undertaking, engines, carriages and all, formed the security of the debenture holder, and that other creditors should be forbidden from seizing engines or any part of the plant, or in any way

[51] *Economist*, February 2, 1867.

[52] Hansard, 185: 787.

[53] Hansard, 185: 781.

[54] The bill was introduced on Feb. 12, 1867. Hansard, 185: 297-299.

[55] Hansard, 185: 781.

breaking up the "living whole" on which the conveyance and convenience of the public as well as the money of the mortgagees depended.

This measure was regarded as both timely and helpful in establishing the desirability of debentures. "No one could doubt," remarked the *Economist*,[56] "that this enactment is beneficial. It amounts to preserving the *interest* of the mortgages from all danger, if the line yields money enough to pay it, because the whole earning machine is kept together and intact to make what gains it can."

It was also felt in Parliament that, in the existing feverish state of the public mind, any attempt to oppose such a measure as the Railway Debenture Holders Bill might conduce to the spread of panic and to create the impression that Parliament was not anxious to strengthen the position of the debenture-holders.[57] Nevertheless, the bill was shelved for a while after the second reading.

Being deeply impressed by the need of protection to the debenture-holders, some members evidently grew impatient with the lack of action of Parliament. Consequently early in April, 1867,[58] a resolution was introduced into the House of Commons to the effect that "in case where adequate security can be given, the state should assume the responsibility of the debenture debt of railway companies unable to meet their engagements, upon conditions providing for the eventual acquisition of such railways by the state upon terms of mutual advantage." In fact the matter of government guarantee had been thought of for some time. In the previous year it was announced that the cabinet intended to adopt a plan for giving a government guarantee to railway debentures and for obtaining a sum of money applicable to the payment of the national debt by that means. The scheme was proposed in various forms, but in its essence it was this: that the government should borrow the money needful for railways at the cheapest rate it could in the market, and lend it to the railways at what was called a "just" rate, namely, a rate which railways had been paying. This process, it was

[56] *Economist*, February 23, 1867.

[57] Hansard, 185: 788.

[58] The resolution was introduced by R. W. Crawford on April 2, 1867. See Hansard, 186: 1025-1063.

hoped, would on the one hand enable the railways to obtain money upon fairer terms than they otherwise could, and on the other hand, enable the government to gain the difference between the rate which it would have to pay and that which it would charge.[59]

So far, so good. But serious objections were at once detected. In the first place it was recognized that the chief reason why the government was an easy borrower — a borrower at low terms — was because it was a small borrower. Even then, there were many dealers who declared that the public were withdrawing from investment in "consols." If a large new loan were asked for, it would likely tax the credit of the government to such an extent as to necessitate a great depreciation. But it was argued, not without reason, that the proposed loan to pay off railway debentures would not constitute a loan for new, additional money. The capital represented in these debentures had been sunk years ago. All that was needed was a transfer from the books of the railways to that of the government. To this it was replied that such a transfer was precisely what would impair the credit of the government. Its securities were then at a scarcity value. The money to be attracted by a low rate of interest was limited and could not be much augmented. Consols were once sold for less than half of their face value,[60] and it was not beyond possibility that a disastrous event like a war might occur to necessitate large loans. In such case, a government guarantee would prove, it was feared, exceedingly embarrassing, if not disastrous.

Moreover, even if the borrowing could have been done properly, it was still almost impossible for the government to fix the "just" rate at which to lend to the different railways. The natural test of a proper rate of interest was the test of the market. The railways which the public trusted would get their money on good terms; those which the public distrusted would get it on bad terms. But it was asked, how could a government charge one railway 5% and another railway 4%. There would at once be a cry of favoritism. Such a process would not only give rise to much complaint, but would also offer a strong temptation to the different lines to corrupt the officials who had charge of de-

[59] *Economist*, November 17, 1866.

[60] In 1797 consols were sold at 47. *Cf. Economist*, November 17, 1866.

termining the rates of interest. Therefore it was urged that the true function of a government in relation to railway credit was to see that the law was complied with. The government should use not its faculty of borrowing, but its function of verification. Thus neither the resolution of Mr. Crawford nor the sentiment of the cabinet in favor of government guarantee, resulted in any action by Parliament.

But many members of Parliament clearly saw that something must be done to prevent the spread of discredit over railway debentures. Therefore, soon after the withdrawal of Mr. Crawford's resolution just referred to, the Railway Companies Arrangement Bill was introduced by the Secretary of State for India. This bill, after being read a second time, was, in conjunction with the Debenture Holders Bill, referred to a select committee, and the two bills were "fused" into the Railway Companies Bill.[61] This measure was regarded as of great importance. Lord Redesdale was even of the opinion that if it had been introduced twenty years earlier it might have prevented many of the difficulties in which the railway companies had become involved.[62]

When the bill was discussed in the House of Lords, a proviso was urged to the effect that whenever a company created any debenture stock having a higher rate of interest than 5%, it should fall to that rate at the end of seven years.[63] But the Duke of Richmond pointed out that the question of limiting the rate of interest had been thoroughly discussed by the committee which examined the bill. This committee felt that the companies which required such arrangements were in most cases — probably in all cases — the best judges of what they needed, and that they ought to be left to borrow money in the manner which they thought best. If they could borrow at 5% they were not likely to pay 6% for it. Therefore, it was thought unjustifiable for Parliament to restrict the companies in fixing the rates of interest.[64]

But the most important and the most warmly opposed part of the bill was that which prohibited creditors from seizing the rolling stock of railways. This modification of the established

[61] Hansard, 187: 1723-1724.
[62] *Ibid.*, 188: 491.
[63] *Ibid.*, 189: 157.
[64] Hansard, 189: 157-158.

law by adding to the legal mortgages of the land estate, as it was called, all the personal property that might happen to be upon it was looked upon as too great a change.[65]

It was, however, clearly recognized that it would be very inconvenient to the public, who also had a right in railways, to have the rolling stock of the company seized by individual creditors, to say nothing of the undesirability of destroying the reasonable security of the debenture-holders, who were the first creditors. When a law gave occasion for the stoppage of the nation's commerce, it should be modified even if it were of old standing.[66]

An objection was raised against such a proposition on the ground that it would deprive the trade creditor of his security. It would give the debenture-holders an unwarrantable advantage over all other creditors of a railway company, with the single exception of the tax gatherers. It was feared that a case might occur where a contractor engaged in constructing a line and desiring payment when the line was finished, would be unable to put in an execution for payment in case the company had issued debentures. The contractor for casual repairs, too, might be brought into such a predicament under similar circumstances. For these reasons, a member of the House of Commons seriously opposed the measure, and thought that it would be more appropriate to call such a measure railway companies creditors' definance bill instead of railway debenture-holders' bill.[67]

Those in favor of the measure, however, denied that such could be the case. However, even if it did so affect the security of such trade creditors, that fact alone was not sufficient to make the measure undesirable. Inasmuch as the bulk of the railway revenue was received in cash, railway companies should pay cash for their stores, labor, etc., and should not get into debt on their account. Moreover, there was in fact a large amount of property left untouched by the bill which could be seized by such trade creditors, if such a course became really necessary. In addition, the trade creditors had recourse to appointing receivers.[68]

[65] Hansard, 185: 783-784.
[66] *Ibid.*, 185: 784.
[67] *Ibid.*, 185: 783.
[68] *Ibid.*, 185: 782.

The opponents to the measure further contended that the clause would encourage solvent companies to delay the payment of their debts. Moreover, it was inexpedient to oblige the creditors of solvent companies to resort to the "cumbrous and perhaps tedious" plan of getting a receiver appointed. If a railway were insolvent, it would itself apply for the appointment of such receivers. In other words, in the case of solvent companies, it would be impracticable and, in the case of the insolvent, it would be unnecessary for the trade creditor to have recourse to the appointment of receivers. Hence he would get no protection whatever from the clause providing for the appointment of such receivers.[69]

To this it was answered that a creditor would have ample remedy inasmuch as a solvent company would, under the provisions of the bill, make immediate payments, while a receiver should be appointed in the case of insolvent companies. No company that was solvent would think for an instant of allowing a receiver to be appointed.[70] It was also urged that if the trade creditors had the power of selling the rolling stock, there would be a serious effect upon the shareholders. Such powers might be pressed at inconvenient moments with the intention of bringing down the shares to a point far below their value, and then the very men who had assisted in bringing about that unfortunate state of affairs might step in and make a handsome fortune out of the misfortune of others.[71] It was further pointed out that it was only the small creditors who would ever be tempted to seize the rolling stock. It would never be worth the while of large creditors to do so. No railway which had the slightest regard for its own reputation would permit its rolling stock to be seized for the purpose of securing small debts.[72] Furthermore, the measure was not directed against existing creditors. As to future creditors, they would be given their credit with the full knowledge that they could not levy execution in case of default in payments. Thus they would be duly aware of what their securities were. To give such creditors the power to apply to the Court of Chan-

[69] Hansard, 187: 1725.
[70] *Ibid.*, 187: 1726.
[71] *Ibid.*, 187: 162.
[72] Hansard, 189: 162.

cery for the appointment of a receiver to seize the tolls of the railway was regarded, therefore, as ample protection.[73]

The opponents also endeavored to introduce an amendment to the measure that should retain the power of seizing the rolling stock in the hands of the creditors, unless the Court of Chancery should appoint a receiver. But this amendment was defeated.[74]

Another new and seriously contested section of the bill was the so-called "arrangement" clause, providing for the creation of "pre-preference" stocks.[75] This provision was opposed on the ground that it would interfere seriously with the rights of the holders of the some £150,000,000 in debentures.[76] Persons who advanced money on debentures did so in the belief that they had a first claim upon the company's receipts; but if Parliament should confer the power of creating preference stocks, the public would be unwilling to advance any more money upon this class of securities in the future. It might be proper to permit the creation of such pre-preference stocks by special act when the particular circumstances warranted such a procedure; but it would be impolitic to confer such powers by a general act.[77]

There was also much opposition among the holders of railway debentures as shown by the fact that a formal protest was lodged against such a provision being inserted in private bills of the session by a large number of bankers and lawyers, as well as by many prominent railway men, in behalf of the holders of railway debentures.[78] These petitioners claimed that the effect of such

[73] *Ibid.*, 187: 1725.

[74] *Ibid.*, 187: 1722.

[75] Pre-preference stocks were securities issued in excess of a company's borrowing powers in case that company became unable to meet its engagements with its creditors. The first instance of the issue of such stocks was that of the Caledonian Railway. In 1851 that company obtained powers from the House of Commons to issue debentures in excess of its powers, for the purpose of paying its debts. At the time the company was in a state of great embarrassment, and the course adopted proved beneficial. It was pointed out in Parliament that in that case the creation of the additional debentures (pre-preference stock was not the name used) was equal to putting a charge over the preference shareholders. Hansard, 187: 1246. For further discussion of this provision in Parliament, *cf.* Hansard, vols. 186-189, under Railway Companies Bill, 1867.

[76] Hansard, 189: 159-160.

[77] *Ibid.*, 188: 590-492, and 189: 163.

[78] *Railway Times*, July 22, 1897.

a provision would be to depreciate or bring into disrepute the security hitherto attached to acts of Parliament. It was claimed that "a large proportion of these securities were held by trustees for infants, married women and widows, or by persons of fixed income, who invested their means in such securities upon the faith of the acts of Parliament, and that such persons would have never made any such investments had they supposed that Parliament would permit their rights to be affected by a later issue of securities of prior lien."

After being committed and recommitted and modified in many respects, the bill was passed and became the Railway Companies Act of 1867. The first important section of this act provided that the creditors of a railway company might obtain the appointment of a receiver, and if necessary, of a manager, on applying to the Court of Chancery to manage the railway, but that the "rolling stock and plant used or provided by a company for the purpose of the traffic on the railway or of the stations or workshops, shall not, after the railway or any part thereof is open for public traffic, be liable to be taken in execution at law or in equity at any time after the passing of this Act, and before the first day of September, 1868. . ."

It may be noticed that the provision for the protection of rolling stock was adopted for only one year. This was due to the fact that such a measure was still regarded as an innovation. On account of the aforesaid opposition and uncertainty as to the practicability of such a measure, Parliament decided to try it for twelve months so as to carry the matter over the next session; and then if it were found absolutely necessary that there should be a sale of rolling stock by the creditors, it could be so arranged by an Act of Parliament.[79]

This precaution proved beneficial. It afforded time to try out the principle and it also gave a great stimulus to all concerned to make close observation, with a view to altering the rule either one way or the other.

The result of the application of the provisions governing the protection of rolling stock proved so advantageous that Parliament in the following year, by a special general act,[80] extended

[79] Hansard, sec. 3, 189: 162.

[80] The Railway Companies Act, 1868, 31 & 32 V. c. 79. This act was enacted for the sole purpose of extending the time-limit to 1870.

the time limit of the provision to three years, that is, until September 1, 1870, and at the end of the three years, Parliament found it expedient to pass another special act [81] for the purpose of making the provision perpetual.

A large part of the act was devoted to defining relations between the company and its creditors. In this connection, ample provisions were made for settling and defining the rights of shareholders of the company as among themselves for raising money by pre-preference stocks. Considerable protection was afforded the holders of the different classes of securities which might be affected by such schemes, through the requirement before a plan could be put into operation of the consent of the holders of three-fourths of each class of such affected securities. Moreover, the scheme must first of all be filed in the Court of Chancery; and after hearing the directors, creditors, or other parties whom the court might deem entitled to be heard and on being satisfied with the nature of the scheme, the court might confirm it. Notice concerning both the filing, as well as the confirmation, of the plan must be published in the gazette.[82]

Besides the provision prohibiting the seizure of the rolling stock, and that for the creation of pre-preference stocks, the Railway Companies Act of 1867 contained a number of other important clauses governing the loan capital of railways. In the first place it provided that, except the claim of the rent charges and lease, "all money borrowed or to be borrowed by a company on mortgage or bond or debenture stock under the provisions of any Act authorizing the borrowing thereof shall have priority against the company and the property from time to time of the company over all other claims on account of any debts incurred or engagements entered into by them after the passing of this Act." [83] Thus by this clause, the holders of debenture stocks were clothed with an indisputable claim of priority against the company over the holders of Lloyd's bonds and other irregular securities. This measure was without doubt urgently needed for improving the desirability of railway debentures.

Section 26 of this act provided that "money borrowed by a

[81] Railway Companies Act, 1875, 38 & 39 V. c. 31.

[82] The Railway Companies Act, 1867, 30 & 31 V. c. 127, ss. 6-22.

[83] 30 & 31 V. c. 127, p. 23.

company for the purpose of paying off, and duly applied in paying off, bonds or mortgages of the company given or made under the statutory powers of the company, shall . . . be deemed money borrowed within and not in excess of such statutory powers."

As we have seen, the railways had much trouble in meeting their mortgages falling due. It has also been shown that there was much difficulty over the fact that securities issued temporarily in excess of the borrowing powers even in anticipation of paying off debentures falling due were sometimes regarded as illegal. By the above provision Parliament endeavored to remove this difficulty; and subsequent events have amply shown that the effort of Parliament was not in vain. That such a provision had been urgently needed, few men who are familiar with the financial affairs of English railways can deny.

To make the debenture stocks more acceptable and easier to issue this act also removed all the restrictions prescribed in the Companies Clauses Act of 1863 as to the rate of interest.[84] Therefore, the companies and their investors were empowered to make whatever arrangements they saw fit in regard to the rate of interest.

Thus closed the legislation on the loan capital of railways in England. Based upon the acts just referred to, the Lord Chancellor in 1869 decided that railway companies should be held liable for all loans irregularly contracted and even in excess of its borrowing powers,[85] thus removing much of the temptation of railways to borrow illegally. Aside from the imposition,[86] since 1868, of a stamp duty of 2 per cent on the nominal value of the debenture stocks transferred, nothing new has been added to the principles laid down up to 1870. In spite of the temporary discontent with these measures of Parliament, the regulations seem to have proven on the whole satisfactory. With the additional security and facility given to railway debenture stocks it soon became common for railways to ask Parliament for powers to issue stocks to be appropriated solely to the liquidation and cancellation of debentures and other periodical loans falling due.[87]

[84] Sec. 25, 30 & 31 V. c. 127.
[85] *Economist*, August 7, 1869.
[86] Sec. 12, 31 & 32 V. c. 124.
[87] *Railway Times*, May 2, 1868.

The desirability of such stocks was well shown by the fact that by 1876 practically all the loans were converted into this class of securities.[88]

Our survey of this aspect of English railway finance leads to certain conclusions, briefly expressed as follows:

1. Other things being equal, long period debts or better still, perpetual and devisible debenture stocks redeemable at the option of the company are more desirable for railways than lump sum loans or mortgages falling due after short periods.

2. The action taken by the English Parliament in 1867 prohibiting the seizure of rolling stock, revealed the advanced ideas of that body and proved to be an effective measure for the establishment of stability in railway finance.

3. The function of a government in regulating the capitalization of railways by loans lies not so much in the adoption of many complicated restrictions as in the enforcement of a few essential rules, with a view of enabling the investor himself to tell the true financial condition of the concern in which he invests.

[88] Board of Trade, General Report on Railway Shares, Loan Capital, etc., 1876.

CHAPTER IV

CONTROL OF THE BORROWING POWERS OF RAILWAY COMPANIES

In early years borrowing powers were granted to railway companies for the purpose of relieving the pressure of calls upon shareholders for new capital. There was no idea then that borrowings should become a permanent charge upon capital. Parliament and the companies alike were of the opinion that the vast profits to be derived from railways would speedily enable the latter to pay off their debts and in addition to declare dividends of a much higher rate than is now expected. The general belief was that railways were to be constructed with capital raised from subscriptions, plus a small proportion of loans for temporary purposes. It is hardly necessary to say that these illusions as to railway profits were soon dispelled. The idea of being able to pay off borrowed money, however, was retained for many years, and was not abandoned until the constant and increasing requirements for renewals, replacements, and improvements had grown beyond all expected proportions.[1]

With such a conception of railway borrowing in mind, Parliament endeavored, from the beginning, to limit the borrowing powers of railway companies as well as to lay down strict rules governing their exercise. Thus, in one of the standing orders,[2] which guided early railway legislation, it was provided that no railway company should be authorized to raise, by loan or mortgage, a sum of money larger than one-third of its share capital, and that until fifty per cent of the share capital should have been

[1] *Railway Times*, August 22, 1863.

[2] Standing Order No. 84. *Cf.* Remarks on Standing Orders by a Parliamentary Agent, London, 1837, p. 55, and *Railway Times*, April 27, 1844. *Cf.* also evidence before the select committee on railways, House of Commons, 1844, p. 29.

paid up, it should not be in the power of the company to raise any money by loan or mortgage.[3]

Thus from the beginning, two principles were laid down. First, no railway company should borrow more than one-third of its share capital; and secondly, no company should borrow at all until one-half of its share capital had been paid up.

The purpose of Parliament in so strictly limiting the powers of railway companies to one-third of their share capital was due first to the general belief, as already mentioned, that railways should be built only with their subscribed share capital, and second to the fact that strict limitation of loans was deemed necessary to give the creditors of the companies adequate security. The stipulation that 50 per cent of the share capital be paid up before the exercising of borrowing powers, was adopted with the hope that such a requirement would tend to place the shares in the hands of substantial investors as well as to strengthen the security of the debentures.

It was also held that no sellers of land or of material to a railway company could be prejudiced by the railway company issuing securities not authorized by the act of incorporation. The company was not entitled to call any credit or to pledge any part of their property for any other purpose, nor should the directors make any contract or sanction any engagements to pay money until they had clearly ascertained that from one or other of the two sources authorized by Parliament they had the power of fulfilling them.[4]

So far so good. But in practice these rules were not always observed. Much consideration was usually given to peculiar circumstances. The standing order just referred to was often "either dispensed with or modified so as to meet the circumstances of the case."[5] In fact another standing order provided for a select committee on standing orders, whose duty it was to

[3] As has been referred to in Chapter I the early railway acts were modelled after the Canal Acts, and the latter in the earliest years gave no power for borrowing. The first acts in which borrowing powers appeared were passed in 1770. By degrees this power of the Companies was restricted to one-third of their share capital. *Report of Royal Commission of Railways*, 1867. ¶ iii.

[4] Letter to the London *Times*, August 23, 1866.

[5] Remarks on Standing Order, pp. 78-79.

"determine whether the standing orders ought or ought not to be dispensed with."[6] Moreover, it soon became clear that not only were the borrowings of railways to remain a permanent charge instead of a temporary obligation as was expected, but that the limit of the borrowing powers was altogether too narrow. The state of the money market and other circumstances frequently made it advisable for a railway company to raise a larger proportion of its capital by loans than the law permitted. Indeed it was only by over-borrowings that some companies continued to pay a fairly good dividend.[7]

Under such circumstances one may readily imagine what happened. When a railway company wished to increase its loans, especially when it could declare bigger dividends by such a process, it would find some way of so doing whether the law permitted it or not. Moreover, the law itself was too imperfect to be effective, for it only stipulated against the borrowing on mortgages and bonds, whereas there were other ways by which money could be borrowed. As was currently remarked at the time, one could always drive a coach and six through any law if he tried hard enough.[8] This was exactly what happened. Money was borrowed in many ways in excess of the legal limit, in spite of the law. The best known expedient for evading the restrictions of Parliament was by the issue of loan notes, for which the directors issuing them were personally responsible. By the issue of such loan notes the companies had "continually exceeded their borrowing powers."[9] Thus the law prohibiting railways from borrowing more than one-third of their share capital on mortgages or bonds was evaded although not violated in letter.

The early restrictive measures upon railway borrowings coupled with what was done to evade them had generally a vicious effect upon the property of the original shareholders, especially when the company was not prosperous. In such cases, the borrowing powers were usually exhausted and hence no money could be obtained through that channel. Loan notes might be issued, but they were obligatory upon the directors

[6] Remarks on Standing Orders, pp. 13-14.

[7] *Railway Times*, April 27, 1844.

[8] Evidence before Select Committee on Railway Borrowing Powers, 1864, p. 22.

[9] *Report of Royal Commission on Railways*, 1867, p. xxiii.

personally instead of upon the company. The directors would naturally become more desirous of relieving themselves of their personal obligations according as the conditions of the company's finance became more desperate. Therefore, they would proceed to Parliament and obtain authority to issue shares either at a ruinous discount, or with an exorbitant rate of interest guaranteed upon them. The result would be an immediate depreciation of the value of the old stocks. The property of the original shareholders, who encountered the risk of forming the company, was often ruined, and the credit of the concern would also sink with the value of the old stocks. Thus it was claimed that the standing order limiting the borrowing powers of railway companies had a tendency either to prevent railways from raising their capital in the most judicious manner or to compel them to issue securities of an irregular character.[10]

Efforts were made, during the forties, to urge Parliament to abolish, or at least to broaden the limit.[11] Nothing, however, was done to remedy the situation. The law was neither modified nor enforced. Like many other stringent laws, it was consistently disregarded. In some cases, sums of money larger than the amount of the total authorized share capital were borrowed through loan notes or other similarly illegal instruments.[12]

The worst effect was that the public did not understand clearly that such loan notes were illegal, and were astonished when it was declared by the select committee of the House of Commons, 1844,[13] that these loan notes were "absolutely invalid," and that the lenders had no means whatever of enforcing the repayment of their money. The issue of such notes was not merely illegal but actually a breach of the original contract under which the act of incorporation was obtained. Thus this select committee on railways felt it highly important to adopt some means to prevent the recurrence of practices so "highly objectionable. . ." [14]

[10] *Railway Times*, April 27, 1844.

[11] *Ibid.*

[12] Report of select committee of the House of Commons on Railways, May 24, 1844. *Railway Times*, June 22, 1844.

[13] Fifth Report of Select Committee of the House of Commons, 1844. *Cf.* also *Railway Times*, June 22, 1844.

[14] *Ibid.*

At the same time it was noticed that although the existing transactions were illegal and contrary to the public policy, they were, nevertheless, of "a perfectly *bona fide* character" as between the borrowers and the lenders. The contracts were entered into without a distinct knowledge of the illegality. Moreover, the money so raised was applied for the execution of the work authorized by Parliament. Therefore, ignorance of the illegality of these securities should be considered.

With these problems in view, the select committee on railways after many sittings at which much evidence was taken, recommended the suppression of the issue of such illegal securities in the future. At the same time, it expressed the opinion that in order to avoid undue hardship upon investors and the danger of disturbing the existing *bona fide* engagements, certain provisions ought to be made by Parliament for the purpose of converting these loan notes into valid securities.

Following the recommendations of this committee, Parliament passed an act[15] in 1844 to the effect that "from and after the passing of the Act any railway company issuing any loan notes or other *negotiable*[16] or assignable instruments purporting to bind the company as a legal security for money advanced . . . other than under the powers of some Act or Acts of Parliament, . . . shall for every such offense" be liable to a fine equal to the sum for which such loan notes purported to be a security. The companies, however, were permitted to renew their loan notes issued prior to the passing of the act for any period not exceeding five years from the passing of the act.

It was also provided that companies should pay off all their notes issued or contracted to be issued before July 12, 1844, as the same might fall due, and that a register of all such loan notes, etc., should be kept by the secretary of the company, which should be open, without charge, at all reasonable times to the inspection of persons interested.

In the Companies Clauses Act of 1845, considerable attention was given to the question of railway borrowing powers. The general rules governing the borrowing powers of railway com-

[15] The Regulation of Railways Act, 1844, 7 & 8 V. c. 85.

[16] Italics are mine.

panies, laid down in this first Clauses Consolidation Act, may be briefly summed up as follows:

(1) Borrowing powers must first be obtained from Parliament.

(2) All borrowings must be executed according to the provisions and regulations contained in the acts granting such powers.

(3) All borrowings must be sanctioned by an order of a general meeting of the company.

(4) In no case must such borrowings exceed in the whole the sum prescribed in the special acts of Parliament, which sum was generally limited to one-third of the share capital of the company.

(5) Fifty per cent of the aggregate sum of the share capital must be paid up.

For the enforcement of these rules, it was provided that the certificate of a justice of peace and a copy of the order of a general meeting should constitute sufficient evidence of powers to borrow. Rules governing the manner of transfers of such securities as well as the registration of the same were prescribed in detail.

To strengthen these rules, it was further provided that "at all reasonable times the books and accounts of the company shall be open to the inspection of the mortgagees and bondholders. . . with liberty to take extracts therefrom, without fee or reward."

Thus within two years, the issue of loan notes, which was one of the most effective instruments for evading the law, was placed under severe penalty, and the general rules governing the borrowing powers of railways as well as the methods for their enforcement were codified into a general act. But in both cases loopholes were left, through which these rules were practically nullified. In the case of the prohibition against loan notes the phraseology of the law led some railways to construe, not without reason, that the enactment applied only to *negotiable* securities, as specified in the enactment, and not to the mere borrowing of money on instruments not negotiable. At any rate, some railways made this their excuse to evade the restrictions against over-borrowing. A new form of notes was soon devised by an expert lawyer which proved to be of greater consequence than

the earlier form of loan notes. In the case of the general law restricting over-borrowing, the regulations, *per se*, were strict enough. But the enforcement of these regulations was left entirely in the hands of the country justices. Under the act, these justices, with their knowledge, or rather lack of knowledge, regarding the complicated system of railway finance and accounting, were depended upon to ascertain whether or not a railway had fulfilled the requirements of the law governing its borrowings; and their findings were final.

Moreover, in spite of the general law, considerable irregularity appeared to have existed in practice. Thus in their third report,[17] the select committee on railways appointed by the House of Commons in 1848, three years after the first general act was passed, pointed out that some bills of that session appeared "to contain irregular or undefined powers of raising money. . ." This committee also pointed out that the most objectionable provisions were the general powers for raising money to pay off debts of the companies, when the bills contained no distinct recital of the facts or specifications of the amount.

In spite of such irregularities, it may be said that the first period of the legislation on railway borrowing powers was closed by the act of 1845. With the exception of the provision contained in the Abandonment of Railways Act, 1850,[18] providing for the reduction of borrowing powers in proportion to the amount of work abandoned, nothing very important was done during the following fifteen years to alter the established rules.

In 1856 agitation for the more strict regulation of railway borrowing powers was revived. A prominent member of the House of Lords[19] endeavored to insert clauses in the railway bills seeking legislation during the session of that year to the effect that no money should be borrowed by a company except on the authority of a minute signed by a majority, at least, of the directors for the time being of the company, and such minutes should be published in the London *Gazette* before any money be raised under the same; and if any money should be borrowed beyond

[17] General Report of the Board of Trade on Bills of the Session, 1863, p. 19.

[18] 13 & 14 V. c. 83.

[19] Lord Redesdale. See *Railway Times*, April 26, 1856.

the powers given by this proposed act, the directors signing the minute authorizing such borrowing should be personally liable jointly and severally for the amount so raised beyond the powers.

The purport of the provision was to prevent the companies from exceeding their borrowing powers, by making the directors personally liable for such offenses. This aroused much opposition. It was feared that it would alarm the public mind and shake the confidence of directors in their colleagues. In speaking of this provision, the *Railway Times* [20] editorially remarked that it was "so fraught with evil, so redolent of injustice, and so hostile to the whole moneyed world that deals or invests in debenture securities, that it cannot be tolerated."

The required advertisement in the London *Gazette* was regarded as worse than useless. Attention was called to the fact that it was not always prudent for a purchaser, and frequently less so for a borrower, to announce that he must obtain a certain sum of money. These announcements in the London *Gazette*, though they might be overlooked by the mass of the community, would be keenly scrutinized by the "sensible" commission agents, who had no money of their own but who played a great part in keeping others' money in circulation. As soon as the advertisement appeared in the *Gazette*, it was feared that "the highest existing rates of interest" would be "uniformly" exacted from the borrowing company.

Moreover, if the directors were made personally liable, as provided by the clause, it would prevent good men from taking up seats in railway directorates. Even without any such liabilities, railway companies had already found it hard to find really "good and upright men to undertake the onerous but thankless duty of directors."

No open opposition was made in Parliament. But the Parliamentary committee in charge of the matter unanimously rejected the clause even without hearing the arguments of those who were prepared to oppose it.[21]

But the question of borrowing powers of railways was still a live one. In the Lands Clauses Consolidation Act of 1860 pro-

[20] *Railway Times*, April 26, 1856, from which the other quotations in this connection are taken.

[21] *Railway Times*, May 3, 1856.

vision was made to the effect that, in case the proprietors of a railway agreed for the purchase of any land in consideration of the payment of a rent charge, annual feu duty or a ground annual, the borrowing power of the railway should be reduced by an amount equal to twenty years' purchase of any rent charge, feu duty or ground annual, for the time being payable.

In the following year the question of the borrowing powers of railways came up again. In petitioning for authority to increase their share capital for the purpose of subscribing to the undertaking of another company, some railway companies endeavored to extend their borrowing powers in proportion to such additions of share capital. On the surface, this extension of borrowing powers seemed permissible, in that the borrowings would be still within the limit of one-third of the share capital. But upon examination the Board of Trade concluded that any extension of borrowing powers based upon the share capital created for the purpose of subscribing to the undertaking of another company was inconsistent in principle with the rule laid down by Parliament which provided that "in the case of a railway bill no company shall be authorized to raise by loan or mortgage a larger sum than one-third of their capital." [22] In order to test the consistency of such extension of borrowing powers, it was necessary to go back to the original object of the rule just referred to. This was that the mortgage creditors of a railway company might have the security of a definite undertaking, on which a subscribed capital was to be paid up to an amount not less than three times as great as the sum to be borrowed. If a company were empowered to borrow on the basis of an increase of its share capital to be used for subscribing to the undertaking of another company, the lender of money so borrowed would not derive any additional security whatever from such creation of new capital, for this additional share capital would not be laid out in the subscribing company's undertaking, on which alone the lender would have a charge, but elsewhere. Thus, the spirit of the rule of Parliament would be destroyed. Moreover, if this request of the railways were granted, the additional share capital

[22] The 126th standing order of the House of Commons and the 189th standing order of the House of Lords. See General Report of the Board of Trade on Railway Bills, 1867, p. 25.

would be made the basis by both the subscribing and the receiving companies for an extension of their powers. Accordingly the Board of Trade recommended that such requests be not granted.[23]

About 1855, as has been shown in a previous chapter, debenture stocks came into vogue as a security in place of debenture bonds, and Parliament took steps to reduce the borrowing powers of the companies in proportion to the amounts represented by the debenture stocks issued. In every railway bill seeking power to issue such stocks, provisions were made to the effect that after the issue of such debenture stocks or the conversion of any mortgages or bonds into such stocks, "it shall not be lawful for the company to issue mortgages or bonds, or any other securities, or again to borrow the sum so converted," and the borrowing powers of the company should be decreased by the amount so borrowed, converted or raised by the issue of debenture stocks.[24]

The growing popularity of such debenture stock led the Board of Trade to make repeated recommendations, beginning about 1858, for the adoption of some general regulations governing the issue of debenture stocks. Among other things, it recommended (1) that the powers to create such stocks should be defined; (2) that money should not be raised by debenture stocks in lieu of borrowing until such money might be raised by the exercise of the borrowing powers of the company; and (3) that to the extent of the nominal amount of the debenture stocks disposed of, the borrowing powers should be extinguished.[25] Following these recommendations of the Board of Trade, Parliament inserted a clause in the Companies Clauses Act of 1863 [26] to the effect that the "power of borrowing and re-borrowing by the company shall, to the extent of the money raised by the issue of debenture stock, be extinguished." As is seen, this was not a new principle, but an old one embodied in a new act.

Thus we see that prior to 1863 the question of the borrowing powers of railways was not of any great popular interest, although it had always been considered of considerable importance in railway legislation. The custom of limiting the borrowing

[23] *Ibid.*

[24] 15 & 14 V. c. 83.

[25] General Report of the Board of Trade on Railway Bills, 1861, p. 24.

[26] 26 & 27 V. c. 118, Sec. 34.

powers to one-third of the share capital of railway companies had been established. The public had seldom thought of changing the established rules. They also imagined that the restrictions laid down by Parliament were observed. With some slight exceptions, the act of 1845 was considered as sufficient to safeguard the interest of the security-holders. In fact there was an idea that the recording of securities by the secretaries of the companies was a sufficient protection without an examination into the details of the company. When the investor got his debenture, he never thought of searching the company's books. It would be useless; "it was never done; people trusted to its being correct." [27]

But under this smooth surface, something unexpected was taking place. The borrowing powers of many railway companies were grossly abused or exceeded. In the first place a cry was raised against the restrictions on borrowing powers to the effect that they were too strict and that the limit was too small. Companies were frequently in urgent need of larger sums of borrowed money either to carry on works or to repay debentures falling due. This difficulty was encountered in the common practice of companies issuing bonds to agents in several of the money-eyed circles in the country. By so doing the company would often suddenly discover itself to have borrowed, through its various brokers, a larger sum than was permitted to it. Then whatever securities were issued over and above the limit were illegal. Such illegal issues, however, were not practically very objectionable, and Parliament often recognized such over-issues in spite of their illegality.[28]

But intentional breaches of the borrowing powers were also made. Some of the companies which were the least entitled to exercise such power were the most eager to exercise it. To get around the restrictions, they resorted to fictitious subscriptions and other improper methods. They filled their subscription lists with the names of "men of straw," and they nominally fulfilled the requirement of having one-half of their share capital paid up not with payments, however, made by *bona fide* subscribers, as contemplated by Parliament, but through the agency

[27] Evidence before select committee on borrowing powers of railway companies, 1864, pp. 6-10.

[28] *Railway Times*, September 12, 1863.

of contractors' contributions or advances made by financial agents. As soon as the requirements of law were in some such way complied with, they would immediately have recourse to their borrowing powers. In many cases, the line was constructed almost entirely with borrowed money, without any funds being left for the equipment or working of the road. Then the promoters would go to Parliament to ask for powers to cancel their ordinary shares which had been created but not disposed of and to issue, instead, preference and other shares with claims prior to those of the ordinary shareholders.[29]

Fraudulent breaches of the law were also quite common. As in the case of the West Hartlepool Harbor and Railway, it was discovered after a protracted inquiry by a select committee that vast frauds had been committed. The company under its three separate acts of Parliament was authorized to raise £2,100,000 with power to borrow to the extent of one-third of the sum paid up for shares. Thus, even if the whole share capital had been paid up, which was not the case, the amount the company would have been empowered to borrow was £525,000. But the company actually borrowed £2,700,000, without any authority from Parliament.[30]

The discovery of this fraud discredited railway debentures more widely than did even the panic of 1847. The mind of the public was appalled when it was shown that all this fraud was done in spite of the "duly authorized, properly circulated" half-yearly accounts and in spite of the service of the "Committee of Assistance" who helped to keep the company's affairs straight. The debenture-holders felt that they possessed no security either in the acts of Parliament or in the returns of the Board of Trade, and much less in the half-yearly accounts of the companies. In spite of all the restrictions and protection which Parliament appeared to have given, he might be robbed of his money at any time.[31]

It was, however, not the mere breaking of the law, but the effect of such breaches upon the investors, that proved especially obnoxious. When a company over-issued securities contrary to

[29] *Railway Times*, May 2, 1868.
[30] Hansard, 171: 1302-1303.
[31] *Economist*, June 22, 1863, pp. 674-675.

law, much hardship must necessarily fall upon somebody. The securities issued over and above the borrowing powers were illegal, and hence the holders of such securities had no status before the law. If the principal and interest were paid to the holders of such illegal securities, the money must come from somewhere. If they were not paid, they would be losers. The holders of the legal securities would justly oppose the reduction of their interest to pay the holders of illegal debentures. They advanced their money upon legal security and they would object to anyone else receiving one farthing until their claims were satisfied. These holders of legal securities, who had no share in the management of the company, certainly should not be made to suffer by the misconduct of persons over whom they had no control. Nor should they in equity suffer simply because other people had lost money upon purchasing illegal securities.

Then it was urged that the holders of the excessive debentures who advanced their money without any legal security should stand the loss. At first sight this appeared permissible. But the true state of affairs showed that this was too harsh a measure. It was true that these holders of excessive debentures had no legal claim to depend upon; but it was also true that this was not entirely their fault. Their money was advanced in a *bona fide* manner. The company had received their money into its hands and had either spent it on its authorized works, or still retained it in its treasury. Moreover, it was likely that neither the shareholders nor the holders of legal securities could have derived their income were it not for the money advanced by the holders of such illegal securities.

Finally it appeared that the shareholders, who in law had the power to appoint directors and the managers of the business and whose employees issued such illegal debentures, should be made responsible. But there were also many practical objections to this course of procedure. In the first place, it was pointed out that these shareholders bought their stocks on the express assurance embodied in the acts of Parliament that there should be only a certain amount of fixed charges against the company with a prior claim over their dividends. Although theoretically they had the power of appointing the managers and directors, many of them, in reality, were no more responsible for the conduct of

their so-called employees than the other classes of investors. They had more enterprising spirit in investing their money in the stocks of the railway, but they certainly should not be punished for that enterprising spirit which was much needed.

All these and many other difficulties as shown elsewhere in our study were direct results of the evasion and overriding of the borrowing powers which Parliament had taken special and constant care to prescribe.

As mentioned previously, the issue of loan notes or other negotiable or assignable instruments purporting to bind the company as security for money advanced, was, since 1845, prohibited. Owing to the narrowness of the limit of borrowing powers and some less laudable reasons, some companies soon discovered an ingenious way to get around this restriction. They devised the well known device of Lloyd's bonds to bridge over the barrier against loan notes. These instruments were issued neither as negotiable securities nor for "cash-advances," but as acknowledgments of obligations for work done, materials supplied, or for debts contracted in excess of their borrowing powers.

The original purpose for which these bonds were devised was, however, not altogether bad, and the circumstances under which they were supposed to be used also appeared to justify their existence. As often happened, a railway company suddenly discovered that its expenditures were underestimated or its resources overestimated. In either case the directors were in difficulty. They were compelled under severe penalty to complete their work within a definite time.[32] Their funds were exhausted. The contractor would refuse to continue the work without pay, and the directors had no money to pay him. Moreover, if the work was left to stand still, not only the capital already spent would remain unproductive and the work itself deteriorate, but the contractor would sue. Naturally a question would arise

[32] In each Railway Act there is always a clause stipulating the time when the line must be completed and the penalty for failure. Clause 34 of the Model Bills of the House of Lords, 1909, says that "if the railway is not completed within five years from the passing of this Act, then on the expiration of that period the powers by this act for making and completing the railway or otherwise in relation thereto shall cease except as to so much thereof as is then completed," and clause 35 provides that deposit money shall not be repaid except so far as railway is opened.

as to what should be done. As the law did not prohibit railway companies from securing their debts contracted for the execution of the *bona fide* purpose of their undertaking, the directors would, therefore, make some sort of an arrangement with the contractor by which they would furnish him from time to time with acknowledgments of indebtedness, under seal of the company, for the amount due to him on account of work done. On these evidences of credit the contractor could secure money. In this way Lloyd's bonds were issued to give time to the debtor company instead of pressing it to issue shares and debentures at great sacrifice.

This was the way in which Lloyd's bonds were originated and in many instances used to the advantage of railways and the public; and they appeared quite desirable. No tenable argument seemed to have been advanced to show that a railway company should not issue to its contractors acknowledgments of indebtedness for the amounts actually due them on account of work actually executed. Indeed, it was claimed that "if restricted to their proper purpose, Lloyd's bonds would have been a useful and certainly not inconvenient invention." [33] But these bonds were soon issued for different purposes. Speculative undertakings were gotten up with hardly any hope of securing money through subscription; and these bonds were issued at "an enormous sacrifice" in order to get the undertaking completed. Ultimately debentures had to be issued. The result of such a procedure was a great extra cost to the shareholders and the owners of the property in general.[34] Swindling schemes were also floated through the instrumentality of these bonds to coerce some existing companies to purchase or lease at outrageous prices.[35]

Moreover the employment of the device tended to deceive the investing public. With the current conception that the borrowing powers of railways were strictly limited, investors were seduced into a belief that the work was so far completed with money raised in accordance with the requirements of the acts of

[33] *Railway Times*, December 15, 1866.

[34] Evidence before Select Committee on Railway Borrowing Powers, 1864, p. 35.

[35] *Ibid.*, p. 19.

Parliament; while in reality their later investments instead of being applied to further prosecution of the work, had to be diverted to the payment of debts of which these new subscribers (the only subscribers, for that matter) were ignorant.[36]

On the other hand it was contended that the complaint against Lloyd's bonds that they represented a violation of the borrowing powers of the company, was unfounded. These bonds could be a violation of the borrowing powers only when they were issued in excess of the borrowing powers of the company; but it was only occasionally that they were issued in excess of such borrowing powers.[37] But this argument neglected the fact that railway companies could violate the law without exceeding the limit of their borrowing powers. The companies were authorized to raise so much money on shares and so much on loans. The latter privilege was not to be resorted to until the whole of the former had been subscribed and one-half of its total amount paid up. Some companies, however, whose undertakings were of such an unpromising character that they could neither secure subscriptions nor make calls, and whose borrowing powers consequently did not materialize legally, would evade the law by resorting to Lloyd's bonds.[38] Although the amount raised was not in excess of the borrowing powers, the issue of such bonds was illegal nevertheless.

Moreover, as is usually the case with such convenient and yet illusive schemes, these Lloyd bonds soon lost their original identity. In fact by 1864, the original purpose and the proper function of these bonds were practically forgotten. Instead of issuing them to contractors for work done in order to relieve temporary pressure, companies used them in coupon form for raising money [39] and also put them into circulation as negotiable securities.[40] Some directors incurred heavy obligations by the issue of these bonds even without consulting the shareholders and without the knowledge of the holders of statutory debentures.[41]

[36] *Railway Times*, December 15, 1866.

[37] *Daily News*, January 18, 1864, quoted by *Railway Times*, January 23, 1864.

[38] *Railway Times*, January 23, 1864.

[39] Evidence before Select Committee of 1864, p. 31.

[40] Hansard, 182: 183.

[41] *Report of Royal Commission on Railways*, 1867, p. xxiii.

Indeed, within a few years after their first use Lloyd bonds became quite extensively circulated, and represented several million pounds in nominal value. In some cases they were even regarded as statutory securities.[42] Thus their extensive application, and the purposes to which they were applied, led the *Railway Times* to say that "no other name than fraud can be given to transactions of this description, and the eminent legal ability which has been exercised in drawing up the instrument so as to keep it out of the range of criminality must accept its share of discredit. . ."[43] These instruments "might or might not be within the strict limit of legality," stated a member of Parliament,[44] "but they certainly had a tendency to be made a most fruitful means of deception and concealment of the real position of the company's affairs."

The effect of this expedient was the total evasion of the statutory limitations of borrowing powers. While the legal borrowings were limited to only one-third of the share capital, the illegal borrowings by Lloyd bonds were subjected to no limitation whatever. Thus the precaution of the legislature for the protection of the holders of statutory securities was nullified. This coupled with the numerous and varied excuses offered by the companies for exceeding their borrowing powers in other ways resulted in much confusion of the whole situation.[45] The investor had no means of ascertaining whether or not the borrowing powers of a company had been exceeded, and consequently whether or not the securities offered by that company were worthless. They had to trust the railway returns made by the companies to the Board of Trade, but they had no means whereby to verify the accuracy of these returns.[46] If these returns were made with strictness, they might in themselves form a good prevention against over-issue of securities, or at least give some valuable information. But these returns, besides not being always accurate, were not made until the end of each year and were not published by the Board of Trade until August or September of the year following. In the meantime the public

[42] Evidence before Select Committee of 1864, p. 127.

[43] *Railway Times*, June 25, 1864.

[44] Marquess of Clanricarde in the House of Lords, Hansard, 190: 1972.

[45] Hansard, 181: 338.

[46] *Railway Times*, September 12, 1863.

had to depend upon such "miserable and imperfect" extracts therefrom as were given in the daily papers.[47] Moreover, the acts of Parliament were sometimes in such a state of confusion that some of the railway companies themselves did not know what their borrowing powers were.[48] Thus the position of the debenture-holders became exceedingly unsatisfactory. By the kind of false shield which had been thrown over the debentures through the limitation of borrowing powers, the public was led to believe that the debenture-holders had a protection which they really never had.[49]

Being faced by such a serious situation, some people advocated that borrowing powers should be abolished altogether. They argued that "this Gordian knot, respecting which so much trouble is taken to render it difficult to unloose, could be cut in an instant. Abolish borrowing powers for the future, except in so far as advances may be made on calls. Let no company . . . raise capital by any other means than subscription for shares. Let existing bonds be converted into debenture stock, and the whole difficulty will be found to have 'vanished like a guilty thing away.'"[50]

Certain members of Parliament seemed to be alive to the serious nature of the situation. A resolution was introduced in Parliament to the effect that the issue of securities should be taken away from the directors appointed by the shareholders and placed in the hands of persons representing the creditors. The extreme character of this resolution reveals to a certain extent the anxiety with which people searched for remedies. But it was regarded as being of too novel a character and was withdrawn.[51]

Parliament, however, felt obliged to take some steps. As most legislative bodies would have done under such circumstances, the House of Lords appointed a select committee in 1863 "to inquire into the whole situation and report as to what legislative measures are desirable for the purpose of restraining the direc-

[47] *Railway Times*, September 26, 1863. Evidence before Select Committee on Borrowing Powers of Railways, 1863.

[48] Evidence before Lords' committee of 1863. *Cf. Railway Times*, September 26, 1863.

[49] Evidence before Lords' Committee of 1864, p. 33.

[50] *Railway Times*, September 12, 1863.

[51] *Railway Times*, August 22, 1863.

tors of railway companies from exceeding the limits of the borrowing powers fixed by the Act of Parliament."[52] The committee made two reports, in which some methods for the enforcement of the rules governing borrowing powers were recommended.[53] In the same year when the Companies Clauses Bill was considered in committee, a member in the House of Commons[54] moved the addition of a clause requiring companies possessing borrowing powers to make an annual return to Parliament of the capital which they had raised, with the object of preventing the recurrence of cases like that of the West Hartlepool Company[55] or any similar violation of the provision forbidding companies from raising money on debentures or mortgage until one-half of their share capital was paid up. The clause, however, was rejected for technical reasons.

But the alarm which resulted from the general lack of information regarding the condition of the borrowing powers of railway companies continued. Therefore in 1864 the House of Lords felt it expedient to appoint another select committee to continue the inquiry commenced in the previous session. The purpose of appointing this committee as well as that of appointing the previous one was to devise some means whereby directors might be restrained from exceeding the limits of their fixed borrowing powers. Parliament appeared to believe that there was no question as to the merits of the established rules limiting the borrowing powers of railway companies. The only thing needed was to find some efficient way of enforcing these rules. Therefore, Parliament reasserted its intention of restricting such borrowing powers through the Railway Construction Facilities Act of 1864[56] in which provisions were made whereby every company which wished to borrow money was subjected to the following restrictions:

(1) "They shall not exercise the said powers of borrowing any money until the whole of the share capital authorized by the certificate is subscribed for or taken, and until one-half thereof is actually paid up, and

[52] Hansard, 181: 385-386.

[53] For the recommendations of this committee, *cf. infra*, Chap. V.

[54] M. D. Hassard. *Cf.* Hansard, 172: 935-936.

[55] See Appendix to Report of Select Committee on Railway Borrowing Powers, 1864, and Hansard, 171: 1302-1303. *Cf.* also *supra*, p. 92.

[56] 27 & 28 V. c. 121.

until they prove to the justice who is to certify under section 40 of the Companies Clauses Consolidation Act, 1845, . . . before he so certifies, that shares for the whole of the capital are issued and accepted, and that not less than one-fifth part of the amount of each separate share has been paid up on account thereof before or at the time of the issue or acceptance thereof, and that all such shares were taken in good faith, and are held by the subscribers or their assigns who are legally liable for the same.''

(2) ''They shall not borrow a larger sum in the whole than one-third of the amount of the share capital authorized by the certificate.''

The latter part of the first clause was especially important, in that it required not only all shares should be taken in good faith but not less than one-fifth of the amount of *each* separate share had to be paid up before a company could resort to its borrowing powers. This provision put a strong check against the practice of inducing ''men of straw'' to sign up subscriptions and using borrowed money to meet the requirement of paying up one-third of the share capital. It has proven so useful that provisions similar to it have been invariably inserted in railway acts since.[57]

This closed the legislative measures concerning the borrowing powers of railway companies. As has been shown, Parliament held from the beginning to the idea of limiting the borrowings of railways to one-third of their share capital, and has consistently adhered to this principle throughout. Whenever the question of borrowing powers came to its notice, all it endeavored to do was to adopt measures to meet the changed circumstances with the purpose of maintaining the borrowing limit. Parliament appeared to believe that the merits and necessity of limiting railway borrowings to one-third of the share capital had passed beyond the stage of argument. All that was needed was to see that the limit was not exceeded. The idea of inquiring into the adequacy of this limit itself did not seem to have been entertained. Nor did Parliament appear especially desirous to find out what were the causes which led railway directors to exceed their borrowing powers. Even the fact that the established custom of borrowing on other good securities invariably warranted a larger proportion of loans than one-third of the share capital failed to induce Parliament to inquire into the advisability of modifying such restrictions.

[57] *Cf.* Clause 7 of the Model Bill of the House of Lords, 1909.

The legal limit of the borrowing powers was thus quite definite. In practice, however, considerable latitude seems to have been given to the companies as shown by the following table:

PROPORTION OF BORROWINGS TO TOTAL PAID-UP CAPITAL

Name of Company	1860	1870	1880	1885	1890	1895	1900	1907
	%	%	%	%	%	%	%	%
Great Eastern		33	32	31	32	31	32	33
Great Northern	15	23	24	25	22	26	25	25
Great Western	28	35	25	24	24	24	25	24
London, Chatham and Dover	20	29	29	29	30	30	31	
London and North-Western	27	28	25	26	27	32	32	32
Mersey			0	22	40	40	41	44
Metropolitan		24	29	27	29	27	26	28
Midland	19	22	23	21	29	28	21	22
North Eastern	28	25	24	24	24	26	31	30

These railways were picked at random, with some reference to their location. The percentages were calculated from the figures given in the Board of Trade returns. It is clearly seen that some of these railways considerably exceeded the limits of their borrowing powers. While the legal limit was 33 per cent of the shares and 25 per cent of the total paid up capital, some of the companies for a number of years borrowed to the extent of 30 per cent or more of the latter capital. The Mersey for a number of years even borrowed to the extent of more than 40 per cent of the total capital. There were other railways which did likewise. The writer does not pretend to say that such "excessive" borrowings were bad in themselves, nor does he maintain that Parliament should not have given some latitude to the enforcement of its rules; but his study of the contemporary opinion leads him to feel that much difficulty arises from the loose enforcement of strict rules.

If the whole railway system of the kingdom is taken into consideration, similar irregularities seem to have existed. Thus, in 1860 the loans equaled 23 per cent, in 1870 they equaled 27

per cent, in 1880, 25 per cent, in 1890, 26 per cent, in 1900, 28 per cent, and in 1907, 27 per cent of the total paid up capital.

So far as the writer has been able to discover, the strenuous adhesion of Parliament to the idea of limiting the borrowing powers of railway companies to one-third of their share capital arose simply out of the desire of giving security, by that means, to the holders of legal debentures. Yet if railways had been permitted to borrow to the extent of one-half or even two-thirds of the *bona fide* share capital it seems hardly likely that thereby the debenture holders would have been deprived of a reasonable security. It hardly admits any doubt that it is desirable for a government to limit the facilities for constructing railways with other people's money; yet too stringent regulations are liable to be as harmful as the lack of regulation.[58] English experience seems to justify the statement that broad but vigorously enforced restrictions may prove more beneficial than narrow but loosely enforced limitations.

Another fact which calls for attention is that one of the chief difficulties which English railways and the investing public had in regard to the question of borrowing powers, was the lack of true information concerning the real condition of such powers and the actual state of affairs of the companies. Half the time, neither the public nor the companies knew what actual powers existed. These facts lead to the opinion that if more efforts were made to clarify railway affairs in general and railway borrowing powers in particular, much difficulty might have been avoided and better results obtained.

[58] *Cf.* Hadley, Railroad Transportation, 1903, p. 54.

CHAPTER V

REGISTRATION OF RAILWAY SECURITIES

From the two preceding chapters it is clear that from the beginning of railway enterprise, Parliament intended to give ample protection to the holders of legal securities, and that for the purpose of affording such protection it endeavored to restrict the borrowing powers of railway companies. It is the purpose of this chapter to elucidate the principal methods by which Parliament tried to restrict such borrowing powers.

In the early acts, by which railway companies were incorporated or enabled to raise money on mortgages or bonds, provisions were made to the effect that an entry or memorial of all mortgages or assignments should be made in the registers of the companies within fourteen days from the time when the assignment or mortgage was made, and that such registers should be open to the inspection of the proprietors or other interested persons at all reasonable times without charge.[1] Provisions were also made requiring the registration of the transfers of such securities in the companies' registers within twenty-one days of the execution of that transfer. It was only after such registration that the assignee might be entitled to the full benefits and payments of the securities transferred.[2] Clauses to the above effect were inserted in the private railway acts during

[1] Section cxix of the London & Croydon Railway Act, 1837, provided that "An entry or memorial of such mortgage or assignment, containing the numbers and dates thereof, and the names of the parties, with their proper additions, to whom the same shall have been made, and of the sums borrowed, together with the rate of interest to be paid thereof, be entered in some book to be kept by the secretary or clerks of the said company; which said book may be perused at all reasonable times by any of the proprietors or mortgagees of the said undertaking or other persons interested therein, without fee or reward."

[2] For the registration of each transfer, the company should be paid the sum of two shillings and sixpence. *Ibid.*

many years, and were found quite beneficial, and so in the Companies Clauses Consolidation Act of 1845, we find general provisions made for the registration of railway securities. In substance, these general clauses were similar to those of the earlier private acts, with the exception (1) that the time limit within which the transfers should be registered was extended from twenty-one to thirty days, and (2) that until such entry (of the transfer) was made the company shall not be in any manner responsible for the transfer of such mortgage, thus making the registration less rigid but of greater consequence to the security-holders. The latter did not appear eager to avail themselves of the provision of the early acts requiring the registration of the purchase and transfer of railway securities. It was felt that unless registration was made a condition of the validity of such securities, the provision would remain a dead letter. Hence, the new provision of 1845 was passed making it necessary to register all transfers in order to render the company in any wise responsible to the transferee.

Thus from the time Parliament began to prescribe the limit of railway borrowing powers, it adopted this system of registration as a means of securing the observance of the same. It thought that since all securities were registered in the companies' registers and since such registers were open to public inspection, there would be little chance for the companies to exceed the limit of their borrowing powers without being at once detected. But although the manner of registration was threshed out with much precision, the execution of such registration was left entirely in the hands of the companies. Prior to 1863, outside of occasional agitations, practically no effort had been made to modify these provisions. The general opinion was that the registration done by the companies themselves was sufficient to prevent irregularities. The public relied, and justly in ordinary cases, on the integrity of the companies.[3] Unfortunately, however, in some cases this reliance was ill-founded. Many companies made so little use of registration that they were not aware of the exact limits of their borrowing powers, as prescribed by Parliament;[4]

[3] *Economist*, May 2, 1863.

[4] Letter in London *Times*, August 23, 1866.

and many others purposely exceeded their limits in borrowing.[5] Indeed, the practice of overborrowing, as remarked the Earl of Donong,[6] actually reached the stage not only of illegality but of fraud. The public were told that Parliament had put a limit to the borrowing powers of railway companies, but they soon found out that under the semblance of this limit money was borrowed every day beyond the authority which Parliament had given.[7] Consequently, doubt, suspicion and dissatisfaction prevailed, which in turn depreciated the value of railway securities so much that they were sometimes called *insecurities*.[8]

This unsatisfactory state of affairs gave rise to agitation. A number of chambers of commerce and other commercial bodies petitioned Parliament in 1863 to modify the existing law, so that railway debentures might be required to be registered and put on the same footing as landed securities. Instead of the registers kept by the companies as required by the Companies Clauses Act of 1845, which really formed no security to the public, it was urged that there should be public registers kept in places of easy access.[9] A scheme for such registration [10] was presented to the select committee of 1863 to the effect that every railway company should be compelled to furnish the lender with a certificate stating that the latter was the registered proprietor of the undermentioned debenture bonds or other securities, duly sealed with the corporate seal of the company.

According to this scheme, these certificates were to be registered in the Bank of England by a public registrar and the registration was to be followed up with a series of acknowledgments which would place it beyond doubt. Holders of registered securities would alone be recognized as bondholders according to acts of Parliament and alone would be entitled to exercise the

[5] The West Hartlepool, the Cork & Yanhol, the Carmarthan and Cardigan, and the London, Chatham and Dover were in this class. *Cf. Economist*, June 20, 1863, Hansard, 182: 1580-1583, and *Economist*, December 22, 1866.

[6] Hansard, 177: 1297.

[7] *Ibid.*, 183: 869.

[8] *Economist*, August 12, 1865.

[9] Evidence before select committee of 1864 on Railway Borrowing Powers, 1864, p. 12.

[10] *Railway Times*, October 3, 1863.

rights of interference which the law accorded to mortgagees. On the other hand, if the holder of such securities failed to register he would not be deprived of his money or of his common law right, but simply of those extraordinary privileges which belonged to the rightful and recognized mortgagees.

To form a complete check, it was also urged that the Board of Trade should be furnished with returns showing the extent of the borrowing powers of each company. Then the proposed public registrar, being in an independent office, should furnish the Board of Trade with a return compiled from the registration of the securities of each company, showing the amount which each company had borrowed. By comparing these two independent returns, the Board of Trade could easily ascertain whether or not a company had exceeded its borrowing powers.

Another plan was proposed by the Deputy Keeper of the Signet of Scotland [11] to the effect that (1) public registers should be kept in London, Edinburgh and Dublin; (2) that all existing companies having debenture debts or stocks should be required to give to the respective registrars a return duly certified as on a certain date, specifying the acts of Parliament under which they were authorized to borrow money, the amount so authorized, the amount which the shareholders had authorized to be borrowed by resolution of general meetings, and the dates of such meetings, together with the amount of debenture bonds and stocks which had been issued and was then due and outstanding against each company; and (3) that all existing and future companies should be required to make returns from time to time of all acts thereafter passed authorizing the borrowing of money or effecting any changes of their borrowing powers.

He also proposed that each return should be registered in a separate book or a part of a book for each company. It should be incumbent on all companies, after the designated date, to transmit to the respective registrars for registration, before they were issued, all debentures and certificates of debenture stocks. The registrar should register these, entering the number, date, amount, etc., in a special form prepared for the purpose. A registration fee was also recommended. Then after such regis-

[11] See evidence before Lords' Committee of 1864, pp. 4-15.

tration the registrar should certify on each instrument the fact and date of such registration.

To form a complete check, he also proposed that it should be incumbent on the companies to send in for registration all debentures or other vouchers of debenture loans or stock which were discharged. These should be registered under a separate heading in the book or part of the book applicable to each company.

This system, it must be observed, was intended for the registration of all debentures or debenture-stock certificates to be issued thereafter. It was suggested that existing debentures should also be registered. The Deputy Keeper of the Signet, however, was of the opinion that it would be rather cumbersome to require the registration of all existing securities. Moreover, such a process would not afford any additional security than that afforded by simply requiring all companies to give the total amounts of securities which they had issued.

Others were of the opinion that it was necessary to have a public register of all transfers and renewals in addition to the registration done by the companies as provided by the Companies Clauses Act of 1845. Although such transfers or renewals did not affect the borrowing powers, their consummation should, nevertheless, be made more definite through a system of public registration. Accordingly, another elaborate form was recommended for the purpose.

A representative of the Board of Trade also suggested a form for registration purposes very similar to this.

Under such a system of registration, it was thought that ample protection would be afforded the public. By these tables the public could see the amount authorized by Parliament, the amount sanctioned by the shareholders to be borrowed, and the number of securities discharged. A comparison of the figures given in the proposed tables would indicate at once how much legal debt was out-standing against the company and the condition of the company's borrowing power. It was also recognized that there would not be much trouble to start such a system of registration, since a similar system of registration had already been used in the case of landed securities.[12]

[12] There were already registration offices under the Companies Act, 1862. *Cf.* Evidence before Lords' Committee of 1864, p. 4.

It was further urged that if the registrars were appointed with definite instructions to register nothing beyond what the companies were authorized to issue, the people would be able to tell at once whether any security was legal or not. It could be safely expected that no man would think of lending money upon debentures which were not registered.[13]

The agitation for a simple and effective system of registration appears to have been most keen; the matter was of wide interest. The general opinion of stock brokers, money-lenders, and the like was unanimously in favor of some sort of governmental registration. The railways as a whole, according to the representatives of some of the leading lines in the kingdom, entertained no objection against the compulsory registration of their securities.[14] Some of them would even welcome such a procedure. The solicitor of the Bank of England, which establishment was then a large investor in the securities of railway companies, was also strongly in favor of such a system of registration.[15] Indeed, the concensus of opinion as expressed before the Lords' Committee of 1864 was that the investors had too much trust in the honor of railway officials in connection with their borrowing powers and that a public registration of railway debentures, if constructed upon some simple principle, was needed to restore and maintain confidence. Such a system of registration would ultimately prove to be an advantage not only to the investing public but to the railway companies as well.

Furthermore, since neither investors nor borrowers were able to ascertain the legality of some of the existing securities, it was asked:[16] Why was it not feasible for the government to investigate and establish the legality of such securities for them? It was suggested that the Board of Trade might effectually do for every person what he could not do for himself, and which, even if it were possible for each individual, would have to be done over and over again by every successive holder of each railway debenture. Thus it was urged that the railway com-

[13] Evidence before Lords' Committee, 1864, p. 12.

[14] More than eight of the influential chambers of commerce openly expressed their desire for such a course of public registration. *Ibid.*, pp. 14-15.

[15] Hansard, 181: 338-9.

[16] *Economist*, May 2, 1863.

panies should be required to certify to the Board of Trade every new issue of debenture. Only after due examination and being satisfied that the company had not exceeded its borrowing powers, the Board of Trade should give the company stamped debentures for that specific amount. According to the opinion of the managing director of the Lands Improvement Company,[17] securities, unless so stamped, should not receive any legal recognition. By this process every debenture holder whose debenture had the mark of the Board of Trade impressed upon it would be sure that he held a good security. The credit of the companies would also be benefited by the removal of the existing suspicion.

The consideration of the matter was taken up by Parliament. As mentioned in a previous chapter,[18] when the special report and evidence upon the West Hartlepool Harbor and Railway bill were presented to the House of Lords, great alarm was felt over railway borrowings by that and other companies. Action by Parliament was obviously necessary if the alarm were not to spread. Accordingly in 1863 the House of Lords appointed a committee on railway borrowing powers to inquire and report as to what legislative measures were desirable to prevent the railway companies from exceeding their borrowing powers. This committee, therefore, recommended[19] that semi-annual declaration of the state of the borrowing powers signed by the chairman, the secretary, and a director of the company should be published in the *London Gazette* by every railway company exercising, or claiming to exercise, borrowing powers under any act of Parliament. In this declaration, the amount paid up and the amount which the company was legally authorized to borrow by the creation of debt, should be clearly set forth. These officers of the company should also declare that the total amount now raised by the company upon bonds or other securities did not exceed the above mentioned amount, upon which the company could legally borrow.

The committee also recommended that thereafter no mortgage

[17] Evidence before Lords' committee of 1864, pp. 22-33.

[18] *Cf. supra*, p. 118.

[19] This part of the committee's report and evidence are published in *Railway Times* for August 22, 1863. See also Report of Lords' committee, 1864, p. 27.

bond or any security for money should be issued by any railway company without having endorsed upon that security a certificate in the following form, to be signed by the chairman and secretary of the company:

"A. B. Railway Company. Date.

Bond for.....No....., being part of the total amount which this company can now legally borrow."

A plan for the registration of all securities by an independent public office was suggested to the committee, but while the committee conceded that such a regulation "might operate for the security of the public," it felt that it did not have sufficient time to give full consideration to the subject.

Parliament did not take any immediate action to give effect to those recommendations. But when the Companies Clauses Bill of 1863 was considered in committee in the House of Commons, M. D. Hassard moved the insertion of a clause requiring companies possessing borrowing powers to make an annual return to Parliament of the capital which they had raised. This motion was rejected on the ground that it was not proper to insert a provision of such importance into a bill which was only intended to consolidate the clauses commonly inserted in companies bills.[20] In the same year, however, in connection with the regulation of the issue of debenture stocks, Parliament adopted a provision for the registration of such stocks. This provision [21] did not contain any new principle. It simply made the rule regarding the registration, by the companies of mortgages, deeds, etc., applicable to the registration of debenture stocks. In the same act, Parliament also adopted a clause [22] requiring all companies to keep a separate account of debenture stocks, showing how much money had been received for or on account of debenture stocks. Also how much money was borrowed

[20] Hansard, 172: 936.

[21] Sec. 28 of the Companies Clauses Act, 1863, provided that the company should from time to time enter the debenture stock created in a register to be kept for that purpose. In the register it was to enter the names and addresses of the persons and corporations who are holders of such stock, with the respective amounts of each; and the register was to be accessible for inspection and perusal at all reasonable times to every mortgagee, etc., without charge.

[22] Sec. 33.

or owing on mortgage or bond, or which they had power to borrow, had been paid off by debenture stock instead of being borrowed on mortgage or bond.

At the same time some members of Parliament also considered the advisability of bringing in a bill for the purpose of carrying out the recommendations of the committee on railway borrowing powers of 1863.[23] But it was feared that those recommendations would be of little value unless provisions were made for general registration of debenture transactions. Moreover, it was still felt that further information was needed on the subject of registration before any efficient system could be adopted to cope with the situation. Therefore, another select committee was appointed in 1864, to continue the inquiry commenced by the select committee of the previous year.[24] In its report, this committee first of all recommended that requirement of a compulsory public registration of railway debentures and debenture stocks as an efficient means whereby to restrain the directors from exceeding the limit of their statutory borrowing powers.[25] The committee was also of the opinion that holders of statutory debentures duly registered should have a right to recover and secure the payment of all principal and interest due to them in priority to the holders of Lloyd's bonds, or of any other obligations or acknowledgments of indebtedness not issued under the authority of Parliament.[26]

Following the recommendation of this committee, the Registration of Railway Debentures, etc., Bill was introduced into the House of Lords in 1865.[27] This bill was in a great measure founded on the report of foregoing committee.[28] It passed the upper house without much discussion, but it went to the lower house late in the session.[29] The promoters of the bill thought it would meet with severe opposition from the powerful railway interests in that house.[30] Therefore, they did not push the

[23] Hansard, 173: 1317.
[24] *Ibid.*, 175: 697.
[25] Report of Lords' Committee, 1864, p. 111.
[26] *Ibid.*
[27] Hansard, 180: 848.
[28] Hansard, 184: 1704.
[29] *Ibid.*, 180: 848.
[30] In 1864 there were no less than 153 railway directors (not to speak

measure vigorously. After being read a second time, it was "put off" for a fortnight, and nothing was done with it that year.[31]

At this time it must be remembered that there was much confusion over the legality of railway securities. Many companies were forced to declare their inability to observe accurately the limits of borrowing powers prescribed by the numerous acts of Parliament. The public also became aware that under the semblance of compliance with the limit prescribed by Parliament, money was borrowed every day beyond the authority given. Parliament itself was forced to recognize the unfortunate state of affairs.[32] It appeared timely to legislate on the matter, but it was thought impolitic to start too stringent rules so as to "make it safe for people to jump in the dark." As a compromise between the extreme views, the Marquess of Clanricarde revived the agitation of the previous year by proposing that every company should be compelled to make periodical returns and that Parliament should adopt some system of public registration so as to enable the people to judge for themselves.[33] In the meantime a bill [34] for the registration of railway debentures, which was substantially the same as that of the previous session, was introduced into the House of Commons.[35] This bill contained thirteen clauses and dealt in detail with the yearly returns to the registrar of joint stock companies, the appointment of assistant registrars by the Board of Trade, and the question of fees, and other questions. It also contained three schedules, of which the first was concerned with the reports on borrowing powers, the second with the registration of the issue of bonds and debentures and of certificates of debenture stock,

of engineers, bankers, or contractors) in the House of Commons, nearly one-fourth of the chief branch of the legislature being thoroughly identified with the railway interest in the country. Some of the railway directors, however, were not returned to Parliament for the purpose of representing the railway interest, others were solicited to become members of railway boards in consequence of their being members of Parliament. *Railway Times*, January 16, 1864.

[31] Hansard, 180: 848.

[32] *Ibid.*, 183: 869.

[33] Hansard, 183: 869.

[34] Bill No. 109, 1866.

[35] Hansard, 182: 1577; 181, pp. 336-338.

and the last with the registration of discharges of debentures and debenture stock.

In spite of the general need of some system of registration, however, the railway interests raised considerable objection to the provisions proposed by this bill.[36] In the first place, they claimed that such a system of compulsory registration would give to the registered securities an apparent validity which they did not have intrinsically, and that it was impossible for the proposed registrar in charge of the annual returns, etc., to ascertain whether bonds submitted to him were or were not issued within the borrowing powers of that company. But the railway interests, as remarked the Earl of Belmore, failed to notice that all the bill proposed to do was exactly what had been done for the preceding 150 years with regard to the registration of deeds in Ireland. All land deeds had to be registered in the Rolls Office in Dublin. This was exactly the proposition as regards the registration of railway securities, and it did not seem probable that the registration in the case of railway securities would give the debentures any more validity than it would convert a false deed in Ireland into a good one. The only object of the requirement was to show the numbers and amounts of the securities issued by each company so that the investors might be able to ascertain for themselves which securities stood in relative priority.

Another objection against this compulsory registration of railway securities was that this requirement would take away from the directors the feeling of responsibility, which they were then supposed to have. If the directors were divested of their duty of looking into the limits of their borrowing powers and were required by law to rely upon the findings of some government office in regard to the exercise of their borrowing powers, they might be induced to shirk the responsibility of keeping their loans within the limit. But this argument could not hold in the face of the fact that many railway directors themselves often did not know either the extent of their responsibility or the exact limit of their borrowing powers.

A general objection was also made on the ground that such registration would interfere with the proper conduct of the companies' business. Extra forces of men would have to be em-

[36] *Ibid.*, 181: 336-338.

ployed in order to prepare the required returns, and the regular business would be interfered with. But the supporters of the bill retorted that no one would deny that the required compulsory registration would mean some extra work for the railways, but that it must also be conceded that the increased value of their securities due to such registration would more than compensate them for any minor inconveniences which they would have to incur.

While this bill was progressing, the Government was also planning to bring in a bill to give effect to some of the recommendations of both of the select committees on railway borrowing powers.[37] Thus, in May 1866, a measure called the Railway Companies Securities Bill was introduced by the president of the Board of Trade into the House of Commons.[38] This bill differed from the Registration of Railway Debentures, etc., Bill in that while the former was based largely on the report of the Lords' Committee on railway borrowing powers of 1863, the latter embodied the recommendations of the committee of 1864.

Soon after the introduction of this measure, the Registration of Railway Debentures, etc., Bill was withdrawn [39] without any discussion. The government measure, after being examined and considered in committees and amended considerably, was adopted and has since been known as the Railway Companies Securities Act of 1866.[40] Its primary purpose was to amend the law relating to securities issued or to be issued by railway companies. The principal provisions may be summed up as follows: (1) Every railway company, on or before January 15, 1867, should register and keep registered at the office of the Joint Stock Companies the names of their secretary, accountant, treasurer, or chief cashier for the time being authorized to sign instruments under the act. (2) Within fourteen days after the end of each half year every railway company should make an account of their loan capital authorized to be raised and actually raised up to the end of that half year, specifying the particulars described in the schedules of the act. (3) The Board of Trade was authorized to prescribe, by notice in the *London Gazette*, the forms

[37] Hansard, 181: 338-339.

[38] *Ibid.*, 183: 1197.

[39] It was withdrawn on July 23, 1866. *Ibid.*, 184: 1279.

[40] 29 & 30 V. c. 108.

in which the half-yearly accounts were to be kept. Such accounts were to be open to the inspection of shareholders, etc., at all reasonable times, without charge. (4) Within twenty-one days of the end of each half year every railway company should deposit with the Registrar of Joint-Stock Companies a copy, certified and signed by the company's registered officers as a true copy, of their loan capital half-yearly account, and it should be unlawful for any railway company to borrow any money unless and until it had first deposited the aforesaid accounts. Failure to deposit such accounts or to register its proper officer should render the company liable to a fine not exceeding £20 for the initial offense and a penalty not exceeding £5 per day during the time which the offense continued. (5) Any person might inspect the documents kept by any registrar on the payment of one shilling for each inspection, and might have certified extracts furnished him on the payment of additional fees. It was further provided that thereafter two of the directors and the registered officers of each company should endorse on every debenture, "each for himself," as stated in the act, that, so far as he knew the debenture was issued duly and was within the prescribed limits to the borrowing powers. In case any mortgage deed or bond was delivered without such a declaration, the company should be liable to a penalty not exceeding £20 for every offense, and if any officer or director knowingly permitted the delivery of such mortgage, deed, etc., he should be personally liable to the same penalty as that of the company. Moreover, if any director or registered officer of a company signed any declaration, account, or statement required by the act, knowing the same to be false in any particular, he should be deemed guilty of an offense against the act and should be liable to a fine or imprisonment.

It may be noticed that all the provisions contained in the act had been, more or less, generally conceded as being necessary. Parliament did not adopt any of the more stringent measures, such as the compulsory stamping of each security by the government, etc., for fear that in trying to require too much at a time the whole program might be either defeated or made difficult of application. Most of the provisions, therefore, were passed without much opposition in either house of Parliament.

But of even greater importance were the provisions governing

the make-up of these returns as required by the act. No matter what efficient rules were adopted to enforce the making of returns, the system would be of little value if the returns themselves were inadequate. It may be remarked that two distinct things were required, namely: (1) half-yearly account of the loan capital of the company, and (2) a statement of the borrowing powers. The half-yearly accounts were required to show the acts of Parliament under the power of which the company had borrowed money, the amounts of loans authorized and the amounts raised by loans, besides other important accounting details;[41] while the statement of the borrowing powers should contain information concerning (1) the acts of Parliament conferring the borrowing powers and the conditions under which the powers may be exercised, (2) the amount of mortgage or bonded debt or debenture stock authorized, and (3) the date at which such conditions have been fulfilled.

This act proved disappointing to some, in that it failed to embody many of the more stringent measures demanded. Thus the *Economist* said:[42]

"English legislation abounds in abortive expedients. It shrinks from difficulties. There is very commonly an admitted evil, and very obviously only one real remedy. But very often that real remedy is painful, and if public attention is but half aroused to the subject, we are apt to put up with some half-measure which gives little or no trouble, which looks as if it might mend matters a little, and which has no disadvantage save that it is not a searching cure of the evil to be remedied, and that in a little while it will be forgotten on account of the slightness of its effect, while the malady itself will rage as much as ever."

"One of these half-way laws is the Act of last session as to railway securities."

This important financial paper contended that the precautions provided by this act failed exactly at the weak point. What was wanted was an independent audit, a warranty by a competent and impartial authority that such and such debentures were

[41] *Cf.* first schedule of the Railway Companies Securities Act, 1866. *Cf.* also *infra*, Chap. 7.

[42] *Economist*, October 27, 1866.

good. "The confusion, not to say worse, of the affairs of some railways has been so great that those connected with all of them are inevitably subject to a doubt. Half of the directors in disorganized railways do not know what is being done, and others wish to do what is illegal. Against such dangers, the act gives no security; it requires certain statements to be made which all the good companies, and 99 out of 100 . . . will make honestly, but which an exceptional company, or rather some few people about such a company, may make dishonestly. As long as you rely on the *bona fides* of the issuer of the debenture you are not, and cannot be, safe from his *mala fides.*" [43]

The act seemed to have failed to check the confusion over debentures at least during the three or four years after its passage. Nor did it prevent some of the companies from exceeding their borrowing powers, as shown by the fact that a good number of railways continued their former practice and that neither the shareholders nor the public were at all aware of the liabilities to which the companies were subject.[44] Moreover, during 1867, the year after the act was passed, many railway properties became greatly depreciated and a feeling sprang up throughout the country that further reform was needed.[45] Thus Lord Redesdale felt it "extremely necessary" to adopt some provisions to the effect that railway securities, unless properly registered, should be regarded as invalid.[46]

In this connection it may be remarked that the apparent failure of the Railway Companies Securities Act during several years after its passage was perhaps due more largely to the special momentum of the established habit of the railway companies to over-borrow rather than the weakness of the act itself. When the state of railway borrowing had reached such a chaotic condition and the companies had become so used to exceeding the limit of their borrowing powers, as they were during the early sixties, it would take some time to make any signal improvement, no matter what measures were adopted. Therefore, the contemporary dissatisfaction and the apparent lack of good results from

[43] *Ibid.*
[44] Hansard, 190: 1962.
[45] *Ibid.*, 190: 1955.
[46] *Ibid.*, 190: 1962.

the act during the years immediately following its enactment do not necessarily prove that the act was ineffective. On the contrary, time seemed to have proven the act of great value in spite of its defects, in helping to restore order out of the financial chaos which existed during the fifties and sixties. An English writer,[47] after criticising the English system of regulation, gave much credit to this act as having done "a great deal towards placing railway finance on a sounder footing. . ."

After the enactment of the Railway Companies Securities Act, Parliament commenced to give its special attention to the adoption of some effective system of accounting as a possible method of regulating railway loan capital as well as other branches of railway finance. Accordingly special legislation for the purpose of regulating the borrowings of railways may be said to have closed with the passage of this act.

Now it may be asked, why did the railway companies exceed the limit of their borrowing powers? What was the reason that directors even risked their personal liability to issue illegal securities? It is true that some directors violated the law for indefensible reasons; but it is equally true that in some instances they were practically compelled to borrow beyond the legal limits. By reason of the restriction of loans to one-third of the share capital the companies were naturally always at the limit of their borrowing powers. Thus the directors were placed under an obligation at a certain time to meet a large amount of debts falling due, whatever might then be the state of the money market. Therefore, they often felt it necessary to raise money beforehand when the state of the money market was easy. Moreover, it often became necessary for a company to create new debts in anticipation of the falling due of the old debts so that its creditors or financial agents might not be able to take advantage of the occasion to embarrass the company. With its loans up to the limit, in issuing fresh debentures, the company in either case would exceed the statutory limit of its borrowing powers.[48]

In answer to the question as to why railway directors, especially of small lines, were willing to evade the law and assume the

[47] J. S. Jeans, *Railway Problems*, p. 23.

[48] *Cf. Economist*, May 2, 1863, and Hansard, 181: 338.

risk of personal liability, the *Economist* said,[49] "But human nature is vain and weak, and the directors are puffed up by the little local importance, and flattered by secretaries who live by the line, and engineers and attorneys who make a large profit out of it, and so they yield and ruin themselves."

Some people felt that the limit of the borrowing powers, which was only one-third of the share capital, was "utterly inadequate,"[50] that the limit was too small compared with the general practice of borrowing on other mortgages,[51] and that too strict rules would invite their evasion. Indeed, it was contended that this inadequacy of borrowing powers was responsible for the gross violation of the limit.

Others felt[52] that it was not within the power of the legislature to put any effective restrictions upon the borrowing powers of railway companies, even if it were proper to do so. If a company wanted to borrow, it would find some way of doing it in spite of the law. Therefore, it was urged that the limit upon borrowing powers should be removed[53] and railways should be allowed to borrow what they liked, provided that they made known all their proceedings. If the public had the necessary information, they might be safely given absolute freedom in advancing their money.[54] If the limit was not entirely done away with, it should at least be extended.

Further it was urged that the borrowing powers of railway companies should be made more definite and the law governing the same should be more strictly enforced. If the railway directors realized that there were absolute limits to their borrowing which it was not possible to evade, they would make better arrangements beforehand, and would not be so speculative. Indeed much of the difficulty was attributed to the facility with

[49] *Economist*, December 14, 1867.

[50] Evidence before Lords' Committee, 1864, p. 34.

[51] The ordinary margin of borrowing with reference to good mortgage securities was two-thirds of the share capital. See evidence before Lords' Committee, 1864, pp. 34-35.

[52] Evidence before Lords' Committee on Railway Borrowing Powers, 1864, p. 24.

[53] Evidence before Royal Commission on Railways, 1867, pp. 803-836.

[54] Evidence before Lords' Committee on Railway Borrowing Powers, 1864, pp. 33-35.

which railway directors in general were able to get their wrongs set right by the assistance of Parliament in patching up their former acts. Although they did not always succeed in getting what they asked for, the hope of being able to do it operated strongly upon them.[55] Parliament in its desire to protect debenture holders by limiting the borrowing powers had led the public to believe in the thoroughness of the protection; while in reality their protection was by no means satisfactory so long as the law was indefinite and loosely enforced.[56] Therefore, it was urged that the limit of the borrowing powers of railway companies should be made more definite and strictly enforced, or that there should be none at all.

Another defect in the law prior to 1866 was that there was not any effectual means to ascertain whether or not the law had been complied with. The law said that railways should not issue any debentures unless and until a certain proportion of their capital had been paid up, but it left the enforcement of this provision to a justice of the peace. It limited the amount that the railway could borrow but in practice could not enforce the limitation. The whole trouble seemed to be briefly this: The legislature had given a privilege of borrowing and had defined the extent of the privilege as well as the conditions under which the privilege might be exercised; but under the circumstances which existed during the sixties no one had any adequate means of ascertaining whether or not the limit had been exceeded or the requisite conditions had been fulfilled.[57] Therefore, it was recognized that the difficulty was a legal one and not an economic one, in that the earning powers of the railways, on the whole, were such as to make a mortgage on railway undertakings "one of the very best securities."[58] Toward removing this difficulty, the agitation as well as the laws adopted during the sixties for the registration of railway securities seem to have done much.

[55] Evidence before Lords' Committee on Railway Borrowing Powers, 1864, p. 27.

[56] Evidence before Lords' Committee, 1864, p. 33.

[57] *Economist*, May 2, 1863. *Cf.* also Hansard, 171: 1303.

[58] *Economist*, October 20, 1866.

CHAPTER VI

REGULATION OF RAILWAY STOCK WATERING

Stock watering by railways may be defined as the nominal increase of railway capital without any commensurate investment of real capital in the concern. It amounts to the fictitious increasing of the capital liabilities by mere book entries and the issuing of unpaid certificates. Stock watering has several forms, chief among which may be mentioned (1) stocks issued partially to represent money, which, instead of being used for improving the property is paid out as dividend; (2) stocks issued to represent an actual increase in the earning capacity and market value of the property; and (3) stocks issued to give certain parties control of the line without actually risking anything like the amount nominally represented by their stocks.[1] Stock watering may be done in many ways, the most important, as it is practiced in England, are those of mere duplication or triplication of existing stocks or the creation of new but unpaid stocks.

Stock watering under the first form came up before Parliament in 1868, in connection with the Regulation of Railways Bill of that year. The Duke of Richmond proposed the insertion of a clause in that Bill to enable railway companies to issue preference shares which had been authorized and remained unissued at the time, in lieu of dividends, in cases where by a vote of no less than three-fourths of the holders of ordinary shares any portion of the amount declared by the auditors to be applicable to the payment of dividends on the ordinary shares is applied to the redemption of debentures or to the execution of authorized works. This proposition was objected to on the ground that it would enable a company to apply its earnings to the construction of new works or the redemption of debenture without paying anything to the preference shareholders.[2]

[1] Hadley, *Railroad Transportation*, 1903, pp. 54-55.

[2] *Railway Times*, May 23, 1868, p. 548.

This objection, *per se*, did not appear valid, for the dividend on the ordinary stock was distributable only after the claims of the preference shareholders had been satisfied. Since the dividend on the ordinary shares of a company was duly earned, as it was required to be in this case, there was no reason why that company, with the consent of the holders of its ordinary shares, should not be permitted to issue its existing preference shares in lieu of such dividends. Indeed, as the *Railway Times*[3] maintained, it appeared strange that the shareholders could not, on their own accord obtain the privilege of paying themselves "in paper instead of in cash." The difficulty appeared to be that Parliament feared the proposal would prove "extremely unjust and that it would probably lead to gross mismanagement, though it would not be open to so much objection if the payment were made in ordinary instead of in preference stock." Some prominent members in the House of Lords[4] contended that "if Parliament could have foreseen the evil which had resulted from the issue of preference stock," it would have never given its sanction to these preference shares. The difference of opinion with regard to this proposition of issuing preference shares in lieu of dividends appeared to be so strong that the bill was withdrawn.[5]

Thus direct stock watering in England has been practiced only under the various shades of the second form. The first form, as has just been shown, failed to receive the sanction of law; and the last form, which is by far the most objectionable, has proved impracticable under the English system of regulation and the conservative business sentiment of the people.

But stock watering has been practiced indirectly, although on a small scale, ever since the thirties. One of these early methods of indirect stock watering was to pay interest on calls before a line was opened, and then charge such unearned interest to capital. This practice became quite common during the forties.[6] From its appearance it was quite harmless, but in reality it was nothing but a pure case of stock watering, in that such charges of unearned interest would swell the capital account to the extent

[3] *Railway Times*, May 23, 1868.
[4] Lord Redesdale *et al.*, Hansard, 192: 420-422.
[5] Hansard, 192: 422.
[6] *Railway Times*, April 27, 1844.

of the interest so charged, without any corresponding addition to capital. Although the magnitude of these nominal additions was small, the effect became rather objectionable. So in 1847, after the panic which followed the great railway extension, the House of Lords adopted a standing order [7] prohibiting the payment of interest out of capital. This was done, however, not primarily for the purpose of preventing stock watering, but to discourage speculation.[8] Nevertheless, this standing order had considerable effect upon stock watering, and remained in force for many years.

This restriction was again emphasized in 1864 in connection with the loans made by the railway companies. In the Railways Construction Facilities Act of that year a provision was made to the effect that railway companies should not, out of money raised under the certificate of the Board of Trade by calls or borrowing, pay interest or dividend to a shareholder on the amount of calls made on his shares.[9]

For twenty years these restrictions remained in force. Practically nothing was done during that period to change them. But in 1882 on behalf of the small undertakings, which were in demand at that time, an effort was made to obtain from Parliament a modification of these restrictions. The reason advanced was that the payment of interest out of capital would offer a great inducement to local investors and small capitalists, who could not afford to put their money into these undertakings without obtaining at once some returns upon it. While the effort was unsuccessful, it brought about considerable agitation, as a result of which the House of Lords in 1886 modified its standing order so as to make the payment of interest out of capital permissible under certain conditions.[10] This relaxation of the law, however, was not accompanied with such good results as was expected. It soon proved that it was the bright prospects of the undertaking and not the power of the company to pay interest out of capital that could induce investors to come forward. So this relaxation of the indirect check against stock watering

[7] Standing Order No. 167.

[8] *Report of Select Committee*, May 19, 1882, p. iii.

[9] 27 & 28 V. c. 121, sub-sec. 3 of section 29.

[10] According to Earl Beauchamp in House of Lords, *Railway Times*, March 16, 1889.

proved to be ill-advised. Since then, however, special provisions have been made to restrict the payment of interest out of capital. Thus the Coventry Railway Act of 1910 provided that no interest should be paid on any share until at least two-thirds of the authorized share capital had been accepted by *bona fide* shareholders, nor should interest accrue in favor of any shareholder when calls on any of his shares were in arrears. The aggregate amount to be paid for interest was also limited to a definite sum, and the company was required to give notice of its power to pay such interest in every one of its prospectuses, advertisements, or other documents inviting subscriptions, so that investors might know what might take place. Moreover, the borrowing powers of the company should be reduced to the extent of one-third of the amount paid for interest, and the half-yearly accounts were required to show the amount of capital on which, and the rate at which, interest had been paid.[11]

Another indirect method of stock watering was to declare unearned dividends. This practice was quite as extensive as the payment of interest out of capital. A member of Parliament[12] was reported to have said that many railways paid dividends out of their capital stock as if they were in a most flourishing condition; and that they sometimes carried the practice so far that their capital no longer existed. This practice once became quite alarming; and the House of Commons felt itself compelled to insert a clause in the Companies Clauses Act of 1845[13] to the effect that companies should not declare any dividend whereby their capital stock would be in any degree reduced. By the Companies Act of 1862, it was also provided in Table A that no dividends should be paid except out of profits earned. But this regulation was not compulsory on the companies registered under that act, for they were empowered by sec. 14 to make rules of association excluding the regulation in Table A. Much conflict consequently resulted between the application of this act and the enforcement of Standing Order No. 167.[14]

But some railways soon found another method of adding water to their capital by the issuing of stocks at a discount. They is-

[11] Sec. 41 of the Coventry Railway Bill, 1910.

[12] Lord G. Somerset. Hansard, 78: 48-49.

[13] 8 V. c. 16, sec. 121.

[14] *Report of Select Committee*, 1882, p. iii.

sued stock certificates for sums larger than were paid into the treasury of the company. This practice also became obnoxious, as a result of which a clause was inserted in the Companies' Clauses Act of 1863,[15] prohibiting the issue of any shares for less than the full amount.

This law lasted three years. Owing to the agitation of the railway interests as well as the changeableness of the attitude of Parliament in railway matters during the period, the law was amended by the Railway Companies Act of 1867,[16] and the provision prohibiting the issue of shares at a discount was eliminated.

There was no debate upon the amendment in the public bill. But the question regarding railways was debated in connection with the proposal made in the Brighton Railway Bill.[17] This company (the Brighton Railway Company) being very much in want of funds proposed to raise money by the issue of preference stocks; but being unable to raise the amount required by such means, they sought to issue ordinary stocks at a discount. The proposal was regarded by the lords as "perfectly new" and of great importance. Lord Redesdale, who recommended the passage of the bill, confessed that it was an objectionable course, but he thought that "it was less objectionable than the creation of preference stocks, and he therefore felt disposed, under the circumstances, to allow the company to issue stocks at a discount." None of the lords who spoke on the question were certain as to the advisability of such a measure; but with the feeling that "when a railway company was in difficulty it was the interest of all parties that money to carry it through should be raised in some way," they did not oppose the measure openly. Following the example of the Brighton, four other companies also obtained similar powers, and £4,043,000 in "water" was added in that year to the railway capital by the issue of stocks at a discount.[18]

By the amendment of 1867 and the interpretations given to that amendment in the cases just cited, it was generally consid-

[15] 26 & 27 V. c. 118, sec. 21.

[16] 30 & 31 V. c. 127, sec. 27.

[17] Hansard, 188: 1423-1424 (July, 1867).

[18] The Chatham & Dover, the Great Eastern, the Sheffield, and the Metropolitan. Fraser, *British Railways*, p. 54.

ered that the issue of shares at a discount was permitted. This freedom was made more unmistakable in 1869 by the Companies Clauses Act of that year,[19] in which it was provided that the repeal of the proviso against the issuing of stocks at a discount was made applicable generally to all companies coming under that act. Thus all restrictions were removed. The railways at once made use of this relaxation of the law; and the issuing of stocks at a discount soon became quite general.[20]

Although these discounts were *ipso facto* nominal additions, they were comparatively negligible in amount and were done only indirectly. Open stock watering was still under the ban of law. There appeared, however, to be much latitude in enforcing the law governing such nominal additions. Since 1867 many railway companies have obtained powers to "convert" their stocks, by which process considerable nominal additions were made. But in most of these cases the "infusion," as it was then called, was still small compared with the capital of the companies, and was made more or less incidental to other arrangements. Out and out stock watering by duplication did not take place until 1888,[21] when a new departure took place under the scheme known as stock splitting. In that year the North British Railway was authorized to make an "absolute duplication" of its existing stock of £5,181,000. By this so-called process of duplication, every holder of the company's ordinary stock on which, say, £100 had been paid, was given a certificate for £200 in the converted stock. In the same year the Great Northern made a nominal addition of £1,803,000, and in the following year the Taff Vale obtained powers to increase its ordinary capital of £1,300,000 two and a half times by the same process. The latter case led Parliament to make its first inquiry into stock watering. We shall, therefore, examine it briefly.

When the bill of the Taff Vale for triplicating the amount of

[19] 32 & 33 V. c. 48, sec. 5.

[20] Evidence before the Select Committee of 1890 on the Conversion of Railway Stocks, p. 39.

[21] Prior to 1890 complete information regarding the amount of nominal addition was not obtained by the Board of Trade, but the Board of Trade's returns of 1890 show a total of £57,800,000. Deducting from this the sum of about £21,000,000 added in 1888, 1889 and 1890, the amount of nominal capital existing prior to 1888 would be about £37,000,000.

its ordinary shares was lodged in Parliament, it aroused considerable anxiety. Therefore, in spite of the fact that it was not the duty of the Board of Trade to examine questions dealing with capital in railway bills, the matter was brought informally to the notice of that board for consideration. The view which that board took on the question was that the proposed nominal increase was so extensive that it ought to be dealt with in a public manner, and should not be allowed to pass as a matter of course, notwithstanding their general opinion that the "greatest freedom should be permitted to companies to arrange their capital as they pleased." Eventually the bill was passed and ample powers of duplication were granted to the company, subject to the provision that surplus profits above 15 per cent on the ordinary capital, or 6 per cent on the new enlarged capital, should be given to the public in the form of reduced rates or improved accommodations. It was also provided that the nature of the nominal increase as well as the old capital should be shown in the accounts of the company, so that every one should be able to understand what had happened.[22]

Leaving the advisability or inadvisability of granting powers for stock watering, for future consideration, we may here mention the erroneous idea which Parliament had in regard to railway finance as evidenced by the proviso under which the extensive powers of duplication were granted to the Taff Vale. Although the high level of the maximum rate of dividend fixed to "balance" the favors granted might have been warrantable at the time by the special circumstances of that company, the method of limiting the maximum was altogether misleading and ineffective. According to that method any surplus above 15 per cent etc. was to be given to the public in the form of reduced rates. It was fairly well recognized then, as it has been generally recognized since, that a railway company under restriction as to the maximum rate of dividend would be constantly tempted to increase its expenditures, whenever its profit promised to exceed that limit.[23] There are always many ways in which a railway company can spend money before it will give it to the

[22] Evidence before the Select Committee of 1890.

[23] "To forbid a corporation to increase its profits is to encourage waste and discourage enterprise." Hadley, *Railroad Transportation*, 1903, p. 102.

public. This was especially true during that period when the system of accounts was ineffective to check up the expense charges of the company.

Then again, the proviso was based on a false premise. The maximum was fixed at 15 per cent only because the company had been declaring an average dividend at that rate during the previous seven years. From this it would follow that a company which might have gone on the principle of charging high or discriminating rates and had thus been enabled to pay high dividends would have its maximum fixed at a high point, whereas a company that had been content with moderate rates would be punished for its moderation by having its maximum fixed at a low level.[24] It is needless to say that such a practice would mean gross injustice.

To the public such a principle would also be unfair. One district would be given a right to receive all profits above say 5 per cent of dividend of the railways serving it, while another district would not be entitled to enjoy such a right until the dividends of its railways had reached say 10 or 15 per cent. But the question of rates is not within the scope of our study. Suffice it to say that strange as it appeared to others,[25] Parliament at the time thought it had gained a great concession from the railway by the provision mentioned and referred to it in subsequent years as a principle to be followed instead of regarding it as a bad practice to be avoided.

The case of the Taff Vale, significant as it appeared to be, was nevertheless only the prelude to what took place immediately afterwards. It was in 1890 that stock watering reached an extravagant scope, and it was in that year when the most important parliamentary inquiry regarding stock watering was made. In 1890 four companies[26] lodged bills for powers to add

[24] "The market value (of railway stocks) depends upon the rate which has been charged. . . ." *Interstate Commerce Commission Report*, Feb. 22, 1911, p. 259.

[25] *Economist*, March 22, 1890, pp. 364-365.

[26] The Isle of Wight, the London & South-Western, the Caledonian, and the Great Northern. The London & South-Western may be taken as a simple and typical example of stock duplication. In the second clause of this company's bill it was provided that the company would create ordinary stock of two classes — (1) preferred 4 per cent ordinary stock and (2) de-

some £36,000,000 nominally to their capital, and those bills were not opposed.[27] The vast interest involved in these proposals at once attracted much attention. The Board of Trade in spite of its policy to favor non-intervention in such matters, thought the question of such an extensive increase of nominal capital to be of "novel impression" and a "new departure so important that it ought not to be passed *sub silentio* . . .," so it urged that the question should be fully debated and the whole matter thrashed out. The chairman of the Ways and Means Committee, under whose hands such unopposed bills were usually disposed of without much discussion, also considered that the vast interests involved in them required special investigation. He disregarded, therefore, the usual rule of procedure, and handled those bills as if they were opposed. Accordingly they were referred to a select committee of nine members, five being nominated by the House of Commons and four by the Committee of Selection.[28] This select committee was empowered to send for persons, papers, and records, etc., concerning both sides of the question, and to consider what provisions should be made for the benefit of the public, if the applications were allowed.[29]

Two distinct questions at once presented themselves for solution, namely:

(1) Whether or not the proposed duplication of stocks ought to receive sanction.

(2) How far it was necessary or expedient for Parliament to interfere with the methods by which the duplication was done, and if Parliament should so interfere, whether the terms and

ferred duplicated ordinary stock, both classes of which to be in substitution of a corresponding amount of the paid up ordinary deferred. That is to say, £100 of the preferred and £100 of the existing ordinary stock should be substituted for every £100 of the existing ordinary stock. It was also provided that the maximum dividend on the preferred stock should be at the rate of 4 per cent non-cumulative, and that the remainder of the net profits would go to the deferred ordinary stock. The voting powers were to remain as before, as if the splitting or duplicating had not taken place. *Cf. Railway Times*, May 17, 1890, and testimony of the representative of the L. & S. W. before the Select Committee of that year.

[27] *Railway Times*, March 22, 1890, and June 21, 1890, p. 784.

[28] Select Committee of the House of Commons on Stock Conversion, 1890, hereafter called Select Committee of 1890.

[29] *Report of Select Committee*, 1890, p. ii.

conditions under which duplication might be done should be prescribed in a general enabling bill.

With these questions before it, the committee, besides taking testimony from the representatives of the railways and other interested parties, called for much independent evidence, among which was that of the representatives of the Board of Trade, the Stock Exchange Committee, and of prominent members of the London and Scottish banking fraternity. A remarkable phalanx of opinion was obtained.

One very striking feature of the evidence on the question of stock watering was that not one of the witnesses thought the practice good in itself. Even those who appeared in behalf of the railways did not attempt to justify it on its own merits. On the other hand, all the witnesses agreed that in principle stock watering should be avoided. But the railway representatives claimed that if the practice were an evil, it was a necessary one, since if they did not do it themselves, the conversion companies [30] were going to do it for them.

The second question upon which much discussion took place was how to ameliorate this necessary evil. What was elicited upon this question was enlightening. The Board of Trade [31] was of the opinion that if the freedom of stock watering were to be generally conceded, it was most important that they should retain a record of the actually paid-up capital as distinguished from the nominal addition. The position of the board was to leave railway shareholders to duplicate, triplicate, or to give any name or units to their capital, for the purpose of buying and selling, that suited them best, "but," they said, "let us take care of the public interest so far as the record is concerned." The

[30] The first stock conversion company was floated in February, 1889. The object of the company, which was new at the time, was to effect the duplication or triplication of the stocks of railway companies independent of the railways themselves. The conversion company, or trust, used its own capital for the purchase of railway stocks, and also gave its own shares and debentures in exchange for any railway stocks that might be deposited with it. Thus, it obtained a considerable amount of railway stock, which in turn was made the basis of a very much larger issue of the trust's own shares and bonds. For details of the working of the conversion company see *Economist*, 1889, p. 596.

[31] For details of the position of the Board of Trade see *Evidence before the Lords' Committee on the Conversion of Stock*, 1890, pp. 37-44.

Board of Trade was also of the opinion that there should be uniformity in recording these nominal additions. If no special act like that of 1868 were enacted, a uniform clause requiring such records should be inserted "as far as possible" in all private bills asking for powers to make nominal additions. It also proposed under the powers of obtaining statistical information conferred by the Railway and Canal Traffic Act of 1888 [32] to obtain and record the same information in the annual returns under the Regulation of Railways Act of 1871.[33] Attention must be called to the fact that the purpose of the Board of Trade in insisting upon the keeping of a clear record of the original paid-up and the nominal capital was "mainly in the interest of the government and the public with reference to the powers with which the companies have been entrusted, and not for the purpose of benefiting or shielding the investing classes in any way." [34]

Whatever the purposes were, all the evidence agreed on the necessity of keeping a clear record of all nominal additions. A practical banker [35] in testifying, believed that to keep a separate record of such nominal additions was very important not only to the railway companies themselves but to the general investors as well. The chairman of the stock exchange [36] considered it very important that the government should insist upon having the original capital placed on the face of the accounts, so that there should be no doubt as to what was the real paid-up capital. By this means, "every person who buys or sells these shares will always have before him every six months what his position is." In short, the consensus of opinion both in Parliament as well as outside of it was that a clear, separate record of the conversion and the converted stocks was necessary for the general interest of the railways and the public. It is interesting to notice that no objection whatever against this requirement was raised by the railways.

The select committee, after examining those witnesses representing different interests, made a special report three months

[32] 52 & 53 V. c. 66, sec. 32.

[33] 34 & 35 V. c. 78.

[34] *Evidence before the Lords' Committee on the Conversion of Stock*, 1890, p. 43.

[35] *Ibid.*, pp. 53-56.

[36] *Ibid.*, p. 47.

after its appointment. As above stated, the committee had to decide two distinct questions: (1) whether the proposed nominal additions ought to receive the sanction of Parliament, and (2) how far it was expedient for Parliament to interfere with the process by which the nominal additions were to be effected. In answer to the first question, the committee said that there was "nothing unreasonable or objectionable from a public point of view in the conversion of ordinary stocks into a preferred and a deferred class," and, therefore, it recommended "that the necessary power for that purpose should not be refused when a railway company desires it." With regard to the second question, which was of general interest, the committee instead of trying to solve it as it was expected, dodged it by throwing the responsibility upon the Royal Commission of 1867 which stated "that Parliament should relieve itself from all interference with the financial affairs of railway companies, leaving such matters to be dealt with under the Joint Stock Companies Act . . ." and the committee urged "that Parliament should continue to act upon the principle of non-intervention . . . believing that while the public are naturally concerned in the solidity and stability of corporations to which Parliament has given large exclusive powers, these objects are, in most cases, best secured by trusting to the self-interest of the shareholders."[37] In order to avoid the confusion inherent in these nominal additions, the committee believed "it right to insist (1) that the dividend should in all cases continue to be declared on the original stock, and (2) that the original stock or paid-up capital shall be recorded and shown in the accounts as though no alteration had been made, . . ." and (3) that the new stock should bear a different and uniform nomenclature.

This report proved, as might have been expected, disappointing to many parties,[38] but not to the railway companies. Throughout its length it showed that the committee took for granted the very matters into which it had been expected to inquire. Most of its conclusions were drawn from the fact that some commission said so and so; and much of the evidence

[37] *Report*, pp. IV-V.

[38] Both the *Economist* and the *Railway Times* published editorials strongly criticising the report.

seemed to have been disregarded. In the first place, the conclusion of the committee that "there was nothing unreasonable or objectionable from a public point of view in the conversion of ordinary stocks . . ." did not seem to be well founded. In the face of the numerous objectionable features of stock watering brought out by the evidence, no one could have expected such a conclusion.

Then the statement made by the committee that the established principle was that Parliament should not concern itself any more with the financial affairs of railways than with those of other stock companies was open to serious question. Parliament had never assented to this principle. On the contrary it had never permitted railway companies to deal with their capital accounts with the same degree of freedom as the ordinary joint stock companies. Numerous facts [39] could be cited to show that Parliament had drawn a clear and broad line of demarcation between the principles governing the finances of railway companies which enjoyed a state conferred monopoly and that of ordinary industrial undertakings. "To assume, therefore, that Parliament had acted on the principle of non-intervention in the financial affairs of railway companies seemed to be directly opposed to facts." [40] Whether the principle involved in stock watering was right or wrong, it was certainly not to be summarily disposed by quoting a twenty-year old opinion which Parliament did not endorse at the time and which in its subsequent actions it had often deliberately set aside.

It must not be inferred from these disappointing features that the inquiry of the committee was entirely fruitless. At least two of the recommendations of the committee have since proved to be sound. The first was that regarding the keeping of a clear record of all nominal additions and the other was that of requiring a uniform and distinct nomenclature to be put on the face of the "watered" stocks. It is to be regretted, however, that sound as these recommendations were, they were shorn of much of their

[39] Parliament has put railway finance upon a different footing from that of other companies by specially authorizing trustees to invest in certain classes of railway stocks. It has reserved to itself the power to deal with the affairs of an insolvent railway; and it has intervened to limit railway dividends, etc.

[40] *Economist*, June 21, 1890.

force and value by the lack of emphasis placed upon their enforcement.

This report was received by Parliament on June 13, 1890. No general or special legislation resulted from the inquiry. But clauses embodying the recommendations of the committee to require the recording of all nominal additions were introduced into the bills then under consideration.[41] Moreover, a precedent was established, according to which similar clauses have continued to be inserted in all subsequent bills for powers to make nominal additions to railway stock. Parliament also occasionally required that dividends be paid on the original ordinary shares, exclusive of the nominal additions, as in the case of the Midland, where it was provided that the "company shall, notwithstanding the conversion, . . continue to ascertain and declare their dividends on the amount of ordinary stock which would have been entitled to dividend if no such conversion had taken place. . ."[42]

Parliament, however, failed to make use of the committee's recommendation of adopting some distinct nomenclature for the converted stocks. Neither was any uniform method of procedure adopted to compel all railway companies to report their nominal additions to stock. An indirect but more effective check against stock watering, however, was adopted in the following year, by the enactment of the Stamp Act in which it was provided that in case of any nominal increases of the share capital, an *ad valorem* duty of 2 shillings per £100 should be charged, with a cumulative penalty for neglect to render due statement of such increases. This measure has been rigorously enforced. Thus the railway companies have been compelled under penalty to pay duty on, as well as to render due statements of, all nominal increases to a government office. It may be added that a further check against unnecessary stock watering was effected by a subsequent enactment in which the stamp duty was increased from 2 to 5 per cent.

In this way, the question of stock watering was disposed of, and the policy for its regulation settled once for all. No new

[41] *Railway Times*, June 14, 1890.

[42] Sec. 67 of the Midland Act of 1897, quoted in Fraser, *British Railways*, p. 68.

departure from the policy has since been made by Parliament. The status thus established may be summed up as follows:

(1) Railway companies shall have freedom to determine their policies and practice in making nominal additions to their capital.

(2) Before such nominal additions are made, the company must come to Parliament for power.

(3) Bills for such powers are dealt with in the same way as any other kind of private bill.

(4) Clauses requiring the keeping of a clear record of all nominal additions as distinguished from the paid-up capital are uniformly inserted in such bills before their passage.

(5) An *ad valorem* duty of 5 per cent is to be paid on the nominal increases and a due statement of all nominal additions is to be furnished to the Stamp Duty Commissioners' office.

By this system of regulation, complete liberty has been given to the companies on the one hand, and publicity has been insured to the public on the other. Although England had to suffer from her leniency toward stock watering, she has never known those vicious schemes of stock watering practiced in the United States. Thus, disappointing as the 1890 investigation and imperfect as the action of Parliament appeared to be, much good was brought about, which was, perhaps, due both to the efficacy of the English system of regulation as well as the readiness of the English railways to mitigate as far as possible the evils inherent in stock watering.

Following the suggestion of the Select Committee of 1890, the Board of Trade in preparing its railway returns for 1890 also endeavored to find some way to give practical effect to the recommendations in regard to the records to be kept. On account of the lack of definite power, the Board of Trade, however, had to request the companies to show in their semi-annual returns the amount by which the various descriptions of their stocks and shares had been nominally increased or decreased.[43] But the "request" of the Board of Trade, though not as effective as a command might have been, proved quite useful, and considerable information regarding nominal additions was obtained from the companies which had added "water" to their capital. These

[43] *General Report to Board of Trade on shares, etc.*, 1890, p. 4.

figures of nominal capital have since been published by the Board of Trade from year to year,[44] to the advantage of the public as well as to the railways themselves. By turning to these returns one may at once see for himself what part of the company's capital represents nominal increases, which information is an advantage in itself as well as a means to clarify confusion and, in a measure, to prevent speculation in stocks.

But, as remarked before, the policy of freedom in stock watering in England was established; and the aforesaid indirect checks against this practice were not felt seriously in some cases. The significance of this policy may be seen from the following table which exhibits the development of stock watering in England from the time when its first record appeared in the Board of Trade returns.

NOMINAL CAPITAL, 1890-1907.[45]

Year	Shares and Stocks Million pounds	Debentures Million pounds	Total	Proportion to paid up capital Per cent	Nominal Increase during year Million pounds	Real Increase during year Million pounds
1890	49.3	8.5	57.8	6.4	6.0	14.9
1891			64.1	7.0	7.0	14.8
1892	53.7	15.0	68.1	7.2	4.0	20.9
1893	53.7	24.4	78.1	8.0	10.0	17.0
1894	54.2	26.8	81.0	8.2	3.0	11.1
1895	56.7	31.8	88.5	8.8	7.5	8.2
1896	68.9	37.4	106.3	10.1	17.8	10.6
1897	114.5	38.0	152.5	14.0	46.2	14.1
1898	139.8	43.7	183.5	16.1	31.0	13.7
1899	141.0	43.8	184.8	16.0	1.3	16.5
1900	142.7	44.2	186.9	16.0	2.1	21.6
1901	143.7	43.7	187.4	15.8	.5	19.0
1902	145.7	43.7	189.4	15.7	2.0	19.4
1903	147.5	43.7	191.2	15.6	1.8	16.8
1904	149.2	44.3	193.5	15.4	2.3	20.5
1905	150.0	44.3	194.3	15.4	.8	13.5
1906	151.0	44.3	195.3	15.2	1.0	13.3
1907	151.5	44.4	195.9	15.0	.6	6.6

[44] In the Board of Trade Annual Returns showing the authorized and paid up share and loan capital of the railway companies, the amounts by

[45] The figures in the table are obtained from the annual Railway returns

From this table, it may be seen that at the time when the parliamentary inquiry was made, £57,800,000[46] or about six per cent of the total paid-up railway capital in the United Kingdom represented nominal additions. This equaled about £3,000 per mile of line opened. The effect of the attitude of Parliament and the Select Committee of 1890 may be seen from what happened during the subsequent eight years, when an average of £16,000,000 in "water" was added annually. In 1895 the nominal addition made was as large as the real increase in capital; in 1896 it was about twice as much and in 1897 it reached the enormous proportion of £46,200,000 which was more than three times as much as the increase of real capital made during that year. This shows how extensively stock watering was practiced during that period. On account of the encouragement given by the findings of the Select Committee of 1890 the railways appeared to have thought that there was a "gold mine" in stock watering, and plunged into its depth. Thus by a stroke of the pen, so to speak, the amount of the stocks of a number of companies was doubled or trebled, without adding anything materially to their properties. The significance of such extensive and violent manipulations can hardly be overestimated. When over 16 per cent of the paid-up capital represents "water," and

which the capital of each railway company has been nominally increased by the conversion, consolidation, and division of their stocks, are shown with figures in italics under the figures of the total capital of each company. There is also a separate table showing, in abstract, the nominal increases of each individual company as well as the whole system. The returns, however, contain no information as to the difference between the nominal amount and the amount actually received of the stocks which have been issued at a premium or at a discount.

of the Board of Trade and the percentages are calculated with a slide-rule. They represent the United Kingdom, but the amount for England and Wales is about 75-80 per cent in almost every case.

The nominal increases due to discount on issue, payment of dividends out of capital stock, are not included in the figures of column of "Nominal increase during year."

[46] Of this amount, £6,000,000 was due to the conversions made by the Midland which has been by far the most important company in stock watering. This company has about £41,000,000 of its nominal capital representing water.

when nominal additions made in a year become three times as big as the increase of real capital, we have something that is at once important. It becomes hard to agree with the Select Committee of 1890 that such stock manipulations as these made no difference whatever to the public.

Another peculiar feature of the English practice of stock watering is that "water" is added not only to the shares and stocks but to the debenture debts as well,[47] and that the nominal additions to these debts, as shown in the preceding table, represent a considerable proportion of the total amount of "water."

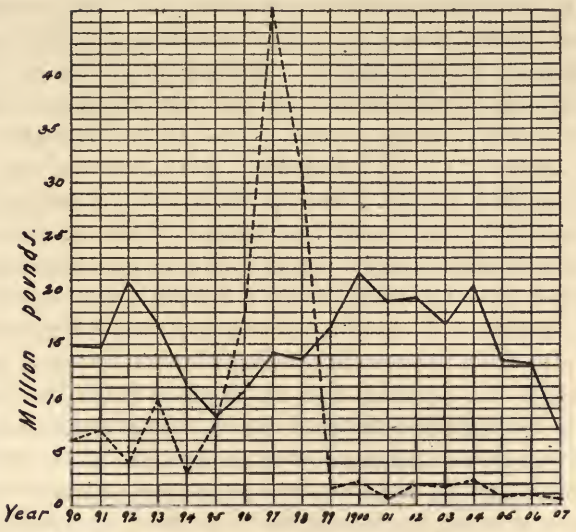
But stock watering reached its zenith in 1897, and its decline has been more striking than its growth. In 1898 the annual increase declined to £31,000,000, and in the following year, it dwindled to the insignificant figure of a little over a million pounds. Ever since that time the annual increase has never been more than £2,300,000, and the practice has continued to decline until it reached the negligible proportion of only about half a million in 1907.

The course of these annual increases may be seen more clearly by the help of the following diagram. In the first place, it may be noticed that the annual increases of nominal capital from 1890 to 1895 were about equal. The curve suddenly commenced to rise in 1896, it reached the highest point in 1897, it commenced to fall in 1898, and it reached a very low point in 1899.

This course is especially interesting when studied with the curve showing the increases of real capital during the same period. Before 1895 the "real increase" curve always stays above the "nominal increase" curve. During the following four years the latter rises above the former by an enormous margin; and since 1899 the "nominal" curve remains considerably below the "real" curve. Then the curve showing the real increases does not have any such violent and abrupt changes as that showing the nominal increases.

These facts also reveal that there is some truth in the principle which had a great influence upon the English legislators that

[47] The watering of the debenture debts has been done usually by giving a new certificate for a debt of say £200 at 2 per cent for a former and actual debt of £100 at or above 4 per cent per annum for either the purpose of making the security more attractive or that of reducing the rate of interest.



Broken line represents nominal increases during year.
Continuous line represents actual additions of capital during year.

railway shareholders would generally find out for themselves what is good or bad, though sometimes after much loss, and to a certain extent explain why Parliament has been so lenient in the regulation of stock watering. But even this self-conviction of the railways could not right what was wrong. While the individual roads had to suffer enormous financial losses in the payment of stamp duties and litigation penalties, the whole system also could not escape from the disastrous confusion created in the minds of the public. In spite of the far-sightedness and moderation of most of the English railways in stock watering, today about £200,000,000, or about $44,000 per mile of line [48] still encumbers the English railway capital, to say nothing of the unrecorded nominal additions, all of which serves to add more confusion and uncertainty to the complicated questions of railway finance.

This leads us to ask why stock watering came into vogue and

[48] The mileage of the United Kingdom given in the Board of Trade returns for 1908 was 12,845, including double track, and 10,263 miles not including second and third tracks.

what were the underlying notions regarding it. First of all, it must be remembered that stock watering has practically never been defended on its own merits. Nothing was elicited from the inquiry of 1890, which was by far the most important of its kind, to justify the practice. Bankers and large merchants regretted the necessity of stock watering, and many railway officials were opposed to the practice. In short, all seemed to agree that stock watering was an evil, because it was nothing but a pure case of misrepresenting actual facts. It was advocated not as anything good in itself, but as a measure of self-defense against the operations of the stock conversion and investment companies. As these conversion companies had achieved some apparent success in securing and duplicating large blocks of railway stocks, the railway directors made their plea for powers to follow the example of the conversion companies. Their reason was that there might be danger to the properties if large blocks of their stocks were merged in successive trusts. If such duplications were a necessary evil, it was better that they should be effected by the railways themselves rather than by certain irresponsible conversion companies, which were making it a business to effect such duplications for speculative purposes. Besides other objectionable features, the special danger apprehended from the operation of the conversion companies was that as holders of large blocks of stock they would possess a voting power which might be used to thwart the policy of the directors conceived in the best interest of the company.

There appeared to be considerable justification for this apprehension. But it must be noticed that the argument of the railway companies postulated that the operations of the conversion company had already proved such a financial success that shareholders had a strong inducement to avail themselves of them. This, however, was not exactly the case. Take the London & South-Western as an example, we find the price of the company's ordinary stock in May, 1889, when the scheme of the conversion company was first put into operation, was £180. At this price, £3,000 would have bought £1,666 of stock. The latter amount of stock sold at the price of £179, which prevailed at the

time [49] when the company lodged its bill for duplication, would have realized £2,970. On the other hand, if an investment of a similar amount were made in the stocks of the conversion company which operated on the London & South-Western stocks, the result would have been as follows: [50]

Amount Invested £	Stock	Issue Price May, 1889	Amount Purchased £	Price in May, 1890	Market Value May, 1890 £
1,000	1st pref'd	100	1,000	99.5	995
1,000	2nd "	104	962	101.0	972
1,000	Deferred	39	2,562	36.0	923
3,000					2,890

From these figures it may be seen that the duplication process as carried out by the conversion company did not work out to the advantage of those who invested in its securities in preference to investing directly in the railway stocks. While the investor who put £3,000 into the ordinary stock of the London & South-Western in May, 1889, got a security which was worth £2,970 a year later when the company wanted to duplicate its stocks, the person who invested the same amount of money in the stocks of the conversion company which represented the London & South-Western stocks, had securities which were worth only £2,890. In other words, the investor who availed himself of the agency of the conversion company had lost £80 more on the capital value of his £3,000 investment than he would have lost had he bought the railway stock itself. In addition he had to suffer loss by paying to the conversion company as commission one-eighth of whatever annual dividend he received. If the Caledonian stocks were analyzed, similar results would be obtained. Therefore, the assumption that the duplication or triplication of railway stocks by the conversion companies had become so attractive to investors as to necessitate the adoption of the same process by the railways seems to be erroneous.

It was, however, generally recognized that the conversion companies by manipulation might exercise some baleful influence

[49] May, 1890.

[50] *Economist*, May 17, 1890, p. 618.

and interfere with the voting power of the railway companies. Stock watering, however, did not appear to be the real remedy, for the railway companies, as was then recognized,[51] could never have hoped to keep pace with the conversion companies in the matter of stock manipulations. Furthermore, even if the railways could have manipulated their stocks as rapidly as the conversion companies, it was no reason why they should be induced to join the gambling ranks of the conversion companies. Both the *Railway Times* and the *Economist*[52] strongly criticised the participation in it by the railway companies.

The foregoing was the principal reason given by the railway representatives before the Select Committee of 1890 in advocating stock watering. But, the reasons emphasized within the walls of the committee rooms are often different from those emphasized without. The case in 1890 seemed to be no exception. For in the report of the Isle of Wight Railway[53] we find the only reason given by the directors of that company to their shareholders in advocating the duplication of stocks was that the process would "(1) increase the capital value of the debenture stocks. . . (2) It will benefit the ordinary stock-holders, because experience has abundantly shown that preferred and deferred stocks . . . are together more valuable than one ordinary stock. (3) It will benefit the preference stockholders" by making their securities more negotiable, and so forth. These might not have been the only reasons in every case but they seemed to be the most important ones why the railway companies wanted to "water" their stocks. Thus it was not the fear of the conversion companies, as emphasized by the railway representatives before the Select Committee that led to the watering of stocks, but the hope of pecuniary gains.

There was no doubt that the railway directors had some reason for believing that stock watering would make the securities more valuable. It must also be admitted that some companies had made some apparent gains from the operation. But, as we have shown, such gains were by no means always the rule. On

[51] *Railway Times*, April 26, 1890, p. 541.
[52] *Economist*, May 7, 1890, p. 619.
[53] *Railway Times*, March 1, 1890, p. 304.

the contrary actual losses have been suffered from such manipulations in some cases. Moreover, even if by stock watering the prices of railway securities were inflated, as was expected, such temporary gains of the existing investors would only mean a corresponding loss to the investors who came afterwards. Indeed, as the *Railway Times* maintained,[54] those who looked to the future must have entertained grave misgivings as to the wisdom and even the honesty of the financial legerdemain involved in stock-watering. It is hardly conceivable that the change of the names of securities could create any lasting and real advantage to the general investor without a corresponding loss to some others.

The reason given by the Board of Trade[55] for permitting stock watering is especially worth noticing. That department shared "the common feeling rather against a watering of capital," but, as said one of its officers, if the railway shareholders desired it, I would "incline to think . . . it is rather covered by the general idea that they should be allowed to do what they please. . ."

One may see plainly that the opinion of the Board of Trade was a negative one. It was one of suspense. They advocated that Parliament should permit stock watering not at all because they thought stock watering was good, but because they thought non-intervention was their policy, and hence, they must follow it.

The immediate effect of stock watering in England has been unmistakably bad. In the first place, this process has unnecessarily added treacherous elements of speculation in railway finance, in turn the cause of much disastrous fluctuations in railway stocks, especially the "adulterated" classes. Genuine investors have been victimized. Many people have sustained disastrous and irretrievable loss from the practice.[56]

Moreover, the process of stock watering, as was prophesied at the time,[57] has conclusively proved to be not only unproductive of any real advantage, but delusive, as shown by the fact that

[54] *Railway Times*, April 24, 1890, p. 541.
[55] *Evidence before Select Committee of 1890*, pp. 42-43.
[56] Fraser, *British Railways*, p. 109.
[57] *Railway Times*, April 26, 1890, p. 41.

"The subsequent balance-sheets can hardly show the true position of the undertaking with so much water added." [58] In spite of the efforts of the Board of Trade to set forth clearly the nominal additions of each company, stock watering is largely responsible for the subsequent misconception of many people regarding the true nature and extent of railway capital in England. It is hard to tell exactly how much harm these nominal additions have done, but it is certain that they have contributed their part to delude future generations into the belief that the English railway system has cost a great deal more than it really has. And this delusion has undoubtedly done more harm than good. Fictitious capital has long been recognized as a real evil in railway finance,[59] and stock watering has, perhaps, created more fictitious capital than any other known process.

The effect of stock watering upon the general investing public is of even greater consequence. The creation of so many nomenclatures for the "watered" stocks at once caused much inconvenience to the holders of existing stocks. As was expected, the misrepresentation of actual facts by this process brought about much confusion. The numerous descriptions of stocks which had been already complicated enough were made altogether beyond the comprehension of any ordinary investor.[60] The public was puzzled as to the value of such securities. The stockholder could not know exactly what was the real position or status of his investment; the new investor was unable to tell the value of what he was buying. As the readiness of an average man to invest varies directly with his knowledge of the steadiness and true value of the securities, these new elements of uncertainty have unquestionably frightened away many investors who would have come forward otherwise.

Abstractly considered, stock watering is also objectionable. It cannot but work to the disadvantage of the general public. A company with an inflated capital account is usually under pres-

[58] McDermott, *Railways*, p. 164.

[59] London *Times*, May 15, 1866.

[60] The best known varieties of ordinary stock are those known as ordinary, as preferred and deferred ordinary, as preferred and deferred converted ordinary, besides consolidated "A" and "B" ordinary stock and "consols." See J. Fraser, *British Railways*, p. 65.

sure to "wring" big profits out of its customers so as to pay dividends on its fictitious as well as real capital.

Again, stock watering, as President Hadley said, has been resorted to in order to furnish an excuse for paying higher dividends than the law or public sentiment would otherwise permit.[61] Indeed an English writer claimed that one reason for the adoption of stock watering in England was that the nominal reduction of dividends would render the companies concerned less liable to attack on the ground of excessive profits.[62]

Moreover, it is generally recognized that the "watered" stocks of a railway company usually have some baleful effects upon the wages which it pays and the rates which it charges. The company with a large capital and consequently a low rate of dividend certainly has a more plausible reason for opposing the payment of higher wages to its employees as well as for objecting to any reduction of its charges than it would have otherwise. Although the actual relation between capital and railway rates is unsettled there is hardly any question that, other things being equal, a company with a low rate of dividend is less liable to have its charges reduced by the government than it would be if its rate of dividends were high.

Furthermore, stock watering seems to have been one of the worst causes in giving rise to speculation, and sometimes, to fraudulent manipulations, both of which results have been responsible in making railway securities a much less reliable form of investment than they might have been.[63] The best managed companies have either been cautious or have never attempted to indulge in stock watering. It is the promoter and the speculator who find opportunities in this practice. It is to the advantage of the general investing public and the responsible railway director to avoid this practice. Indeed, the phrase of stock watering is still altogether indefinable, and the evil effects of stock watering have been recognized in the United States as well as in England.[64]

[61] Hadley, *Railroad Transportation*, 1903, p. 55.

[62] E. R. McDermott, *Railways*, p. 164.

[63] E. R. Johnson, *Am. Railway Transportation*, 1907, p. 94.

[64] Of the nine witnesses who testified before the U. S. Industrial Com-

The principle, or rather the lack of principle, involved in stock watering "is to be deprecated." [65] It is "opposed to conservative railroad financiering;" [66] it gives rise to objectionable speculation and gambling,[67] it leads to pursuing a short sighted policy; [68] it should be "emphatically condemned;" [69] it "is a practice against which Parliament should have resolutely set its face." [70]

Thus, from all the evidences, statistics, and authorities consulted and after examining the principal reasons given by various parties, we are led to conclude that stock watering in railway finance is objectionable.

Now what shall be the remedies? No general rule can be laid down for all countries, nor, perhaps, could any be laid down for the same country for all times. Any empirical formula or dogmatic doctrine is liable to be useless, or even harmful. But taking England as an example, it seems that more strict rules were warranted and could have been adopted for the regulation of railway stock watering. Even at the time when the practice was most vigorously advocated, there did not appear to be much objection against more stringent measures than those adopted by Parliament. The only excuse we find for the attitude of the select committee of 1890 and the legislature in giving much freedom to stock watering was that the established principle seemed to be non-intervention. It is hardly necessary to emphasize that to fall back always on old principles in order to solve new problems is a dangerous policy. Even the English people are opposed to all kinds of government interference, it seems that Parliament could have done more to safeguard the public interest. If nothing else, it certainly could have required the appearance

mission of 1900 in regard to stock watering, every one was of the opinion that the practice was harmful. Chief among these witnesses were Professors Seligman, Johnson and Newcomb. *U. S. Industrial Commission Report*, 1900 V, IV, pp. 25 *et seq.*

[65] E. R. McDermott, *Railways*, p. 164.

[66] E. R. Johnson, *Am. Railway Transportation*, 1907, p. 90.

[67] *Railway Times*, April 26, 1890, p. 541.

[68] Hadley, p. 22.

[69] *The Economist*, Feb. 9, 1889, p. 172.

[70] *Ibid.*, July 13, 1889, p. 891.

of uniform nomenclature on the face of the converted stocks as recommended by the select committee. It could have enacted some law to enable the Board of Trade to compel instead of to request the companies to furnish returns showing the nominal additions as distinguished from the actual capital; and it could have enacted a general law so as to insure uniformity in the whole matter, instead of leaving it to be dealt with piecemeal.

On the other hand, we must not criticise the English Parliament according to our understanding of what stock watering means in the United States. In the first place, the "worst forms of stock watering, unhappily so common in America . . . is practically unknown in England."[71] If at all, stock watering must be done openly. It must be sanctioned by Parliament. Such publicity removes much of the temptation to effect stock watering for dishonest purposes. Moreover, the indirect checks imposed by the Stamp Acts have made stock watering quite difficult. Let stock watering be done openly and be investigated first by some dignified government office, it will disappear on its own merits. Therefore, stock watering in England, extensive as it is, has never been nearly as objectionable as in some other countries. Moreover, the English railways seem to have seldom if ever, "watered" their stocks for dishonest purposes. They also appear to have been eager to help the government to prevent the difficulties inherent in stock watering. Hence a request of the Board of Trade has been sufficient to secure full information regarding their nominal additions made each year. Thus by turning to the annual railway returns of the Board of Trade, one may see at a glance what proportion of the capitalization of each company represents water. This difference partially explains why Parliament has taken such lenient measures in regulating it.

Thus, it appears that publicity is one of the most effective and practicable checks against objectionable stock watering in railway finance. To insure this, railway companies should be compelled to show in their accounts and balance-sheets all their nominal additions. They also should be required to furnish periodic and due statements exhibiting clearly such nominal additions as distinguished from the actual capital, with remarks as

[71] Hadley, *Railroad Transportation*, 1903, p. 156.

to the time when, and circumstances under which, the additions were made. A uniform nomenclature should be marked on the certificates of all adulterated stocks so as to avoid confusion. It further appears that stock watering in railway finance should be discouraged and placed under government supervision in all cases, and prohibited whenever circumstances permit.

CHAPTER VII

THE REGULATION OF RAILWAY ACCOUNTS

The English legislature took pains to regulate railway accounting as early as it endeavored to regulate other branches of railway finance; but it did not prescribe any precise system of accounting before 1868. The keeping of accounts had been obligatory upon the railway companies in common with other joint stock companies. For this purpose separate provisions were made in the special acts of incorporation. Thus a clause in the Croydon Act of 1837 [1] provided:

"That the said directors shall cause a book or books to be kept by a book-keeper who shall be expressly appointed by the said directors for that purpose, and who shall enter or cause to be entered in the said book or books true and regular accounts of all sums of money received and expended for or on account of the undertaking . . . ; and such book or books shall at all reasonable times be open to the inspection of the respective loan creditors . . . without fee or reward, and the said loan creditors or any of them may take copies of or extracts from the said book or books without paying anything for the same; and in case the said book-keeper shall refuse to permit such loan creditors or any of them to inspect such book or books, or to take such copies or extracts as aforesaid, such book-keeper shall forfeit and pay over for every such offence any sum of money not exceeding £20."

In 1841 a member of Parliament inquired of the president of the Board of Trade as to whether it had not become necessary to take evidence to show that all railway companies should periodically furnish to the Board of Trade a debtor and creditor account, drawn out on a simple but uniform plan, of their half-yearly receipts and expenditures, etc. To this inquiry, however,

[1] I V. c. cxix, s. CLXXXVIII.

the president of the Board of Trade answered that he did not think that it had become desirable to make any such regulations.[2] This last statement shows how little value was attached to uniform accounting during the forties.

In 1842 in connection with the collection of stamp duty on passenger fares, a clause was inserted in an act of that year[3] to the effect that all companies should keep accounts of their passenger receipts in such form as should be prescribed by the commissioners of stamps and taxes, and should, within five days after the first Monday in each calendar month, deliver to the said commissioners or other duly appointed officers a true copy or copies of the accounts so kept. Another section[4] of this act provided that all books containing passenger receipts should be open to the inspection of officers of stamp duties, under penalty of £50 for each offense against the law.

For the purpose of government purchase of railways, a clause was introduced in the Railway Regulation Act, 1844,[5] to the effect that, during the period of three years previous to the time when option of revision of rates or state purchase of a railway should become available, true accounts should be kept of all sums of money received and paid, that a half-yearly account in abstract should be prepared, showing the total receipt and expenditure, and that these accounts should be open to public inspection.

This general provision as well as those contained in the act of 1842 just referred to, were, however, not made primarily for the purpose of regulating accounts. It was not until 1845 that general provisions were made to regulate railway accounts. In the Companies Clauses Act of that year,[6] no less than eight clauses were devoted to the regulation of this branch of railway finance. By this act, railway directors were required to cause "full and true accounts to be kept of all sums of money received or expended on account of the company . . . and of the matters and things for which such sums of money shall have been re-

[2] Hansard, 73: 1070-1071.
[3] 5 & 6 V. c. 79, s. lv.
[4] Section V.
[5] 7 & 8 V. c. 85, s. 5.
[6] 8 V. c. 16.

ceived or disbursed. . .'' The act further provided [7] that the books of a company should be balanced at the prescribed periods,[8] and an exact balance sheet should be made up, exhibiting a true statement of the capital stock, credits, and property of every description belonging to the company, as well as the debts due by the company at the date of making the balance sheet. A distinct view of the profit or loss which might have arisen in the course of the preceding half year should also be presented. Such balance sheet was also required to be examined by at least three of the directors, and was to be signed by the chairman or deputy chairman of the company. Moreover, both the shareholders and mortgagees were authorized to have access to these accounts at the prescribed or other reasonable times, with the liberty of taking extracts therefrom without charge.[9] In the Railways Clauses Act of the same year,[10] a further provision was made to require, under penalty,[11] railway companies to prepare and transfer to the clerks of the peace and the over-seers of the poor of the counties and parishes traversed by the railway, abstracts of their annual accounts.

The financial depression caused by the railway mania of 1847 led to some investigation of the accounts of railway companies. A committee of the House of Lords was appointed in 1849 to consider ''whether the railway Acts do not require amendment, with a view of providing for a more effectual audit of accounts to guard against the application of the funds of such companies to purposes for which they were not subscribed, under the authority of the Legislature.'' [12] This committee pointed out that a serious omission in the existing law was the want of any prescribed and uniform system of accounts, and recommended the enforcement of some statutory forms to be binding, within cer-

[7] Section 116.

[8] If no period is prescribed, then the balance should be made fourteen days at least before each ordinary meeting.

[9] 8 V cap. 16, ss. 55 and 117-119.

[10] 8 V. cap. 20, s. 107.

[11] In case any railway company should fail to prepare or transmit such accounts as required by law, it should forfeit for each failure the sum of twenty pounds.

[12] *Report of Royal Commission on Railways*, 1867, p. xviii.

tain limits, upon all railway companies.[13] It further proposed that the statutory forms should embrace the following particulars:[14]

1st. A full statement of all the parliamentary powers granted for raising money, showing the undertakings to which they were applicable; the manner in which the money had been raised; the nature of securities issued under each act, with the conditions and rate of interest applicable to each, and the amount of money obtained and in arrears; and the balance of parliamentary powers unexhausted.

2nd. A capital account explaining how the money shown as having been raised under the parliamentary account had been dibursed, and

3rd. An account of the ordinary income and expenditure of the railway company.

It also recommended that separate accounts should be kept for separate branches of the enterprise of every company.

Moreover, it was further urged that the right of inspection by shareholders of the companies' accounts should be unrestrained; that all accounts without exception touching or relating to the receipts or payments of each company should be required to be produced, and that in case of refusal the statutory penalty should be extended from the book-keeper to the governing body.

About the same time, the Railway Commissioners[15] also voiced the opinion, apparently with the general approval of the railways, that the companies should specify in their accounts every loan contract, the period for which it was contracted, with the rate of interest and the liquidation of such loans or portion thereof as might be made from time to time.[16]

These recommendations, practical as they were, failed to mature into legislation. They were too much out of line with the *laissez faire* ideas of the time.

During 1859 to 1862, the Board of Trade persistently recommended that separate accounts should be kept of the amounts of

[13] *Report of 1909 Departmental Committee on Accounts, etc.*, p. 4.

[14] *Report of Royal Commission on Railways*, 1867, p. xciii.

[15] These early railway commissioners had the duty of examining railway bills and differed materially from those appointed since 1873.

[15] C. L. Webb, *Letter to the President of the Board of Trade*, 1848, pp. 59-60.

debenture stocks created and disposed of, and of the application of the money raised by such issues.[17] It was, however, not until 1866 that Parliament began to give effect to some of these recommendations. In the Companies Securities Act, 1866, provisions were made to require all railway companies, within fourteen days after the end of each half year, to make an account of their loan capital authorized to be raised and actually raised up to the end of that half year. In the account, the railway companies were required to specify the following particulars, in addition to what was required by former acts.

(1). The amount or prospective amount of loans authorized or confirmed by Parliament;

(2). Whether or not the obtaining of the certificate of a justice for any purpose, or the obtaining of the assent of a meeting of the company, was made a condition precedent to the exercise of the borrowing powers;

(3). The date at which such condition was fulfilled;

(4). The aggregate amount of the company's existing debts contracted on mortgage, bond, or debenture stock, up to the end of the half year; and

(5). The aggregate amount remaining to be borrowed.

Then the second and every subsequent half-yearly accounts were required to show the items described in paragraphs (1) and (4) for two consecutive years, and the increase or decrease of any of those items in the second of those half years as compared with the first. The Board of Trade was authorized to prescribe, by public notice in the *London Gazette*, the forms of the half-yearly accounts of the loan capital of railways from time to time.[18]

The act further provides that within twenty-one days after the end of each half year, every railway company should deposit with the registrar of joint stock companies, a copy, certified and signed by the company's registered officer as a true copy, of their loan capital half-yearly account. Moreover, these accounts were to be open to the inspection of shareholders, stockholders, etc., at all reasonable times without charge.

Furthermore, the act made it unlawful for any railway com-

[17] *General report of the Board of Trade on Railway bills*, 1861, p. 23.
[18] 29 & 30 V. cap. 108, s. 6.

pany to borrow any money on mortgage or bond, or to issue any debenture stock, "unless and until they have first deposited with the registrar of joint stock companies . . . a statement certified and signed by the company's officer" in the prescribed manner.[19]

By this series of enactments, Parliament "endeavored to secure a faithful record and account of all the financial transactions of the companies to be kept under the authority of the directors; a power for any shareholder within limited bounds to examine the company's accounts; the periodical exhibition of a balance sheet showing all the capital, stock, credits, and property of and debts due by the company, and giving a distinct view of the profit and loss; and the payment of a dividend out of profits, coupled with a prohibition against reduction of capital by means of dividends. . ." [20]

It may be observed, however, that all except the last one of the statutes referred to were enacted for the purpose of requiring the companies to keep accounts according to their own way, without any governmental interference. Even the act of 1866 just referred to went no further than to authorize the Board of Trade to prescribe and alter some forms of loan accounts. Indeed, it was not until the report of the Royal Commission on Railways of 1867 had been made that steps were taken by means of the Regulation of Railways Act, 1868, to give effect to the far-sighted recommendations of the select committee of 1849 regarding the adoption of a uniform system of accounts. We shall, therefore, examine (1) how the results of the old system of regulation of railway accounts led to the adoption of the new system of 1868, (2) the nature of the principles set forth in the new system, (3) the defects of the new system, and (4) what Parliament has done since.

The early system of regulation required railway companies themselves to keep true and clear accounts of all their incomes and disbursements for the purpose of preventing irregularities in the application of the companies' capital. This was based on the assumption that the ordinary maxims of prudence and good faith, combined with the usual practice of persons engaged in commercial affairs would be sufficient to secure the observance

[19] 29 & 30 V. c. 108, s. 10.

[20] *Report of Royal Commission on Railways*, 1867, p. xxiii.

of these regulations.[21] "Unhappily," as it was remarked in the House of Commons in 1867,[22] "the fact was far otherwise." It was true that railway companies always kept accounts and uniformly prepared a sort of balance sheet every half year; "but it was frequently such as no merchants or bankers would be satisfied with." It was claimed that a great number of companies considered a balance sheet a means of mystifying and misleading their proprietors and the public, and that balance sheets were often used to conceal the real state of a company. It has even been said that the balance sheet of a railway company has no more effect than a sheet of waste paper.[23]

Moreover, there was no uniformity whatever in the matter of railway accounts during those years.[24] One company had one form of accounts; a second one, another; and a third one a form still different. It was not only impossible to compare the accounts of the different companies, but also impossible even to compare the accounts of the same company for different years.

Regarding the prohibition against the wrong application of the companies' capital, Sir William Hunt in introducing the railway and joint stocks companies' account bill, 1868, said,[25] that no one could read the act of 1854 for the consolidation of railway and joint stock companies, or the Companies' Act of 1862, without being struck by the grave and imperative language in which the acts directed that no dividend should be paid unless their accounts showed that the dividend has really been earned, and could be paid out of the net profits of the company. But in this case also the law has proved ineffectual. Directors were often tempted to disregard all the moral and legal obligations in order to make things look "pleasant" to their proprietors. Dividends were frequently declared out of capital, until it became impossible to tell whether or not it was really earned.[26]

The effect of this practice was that railway shareholders were so "bewildered and mystified by cooked accounts, manipulated figures, partial statements, and delusive representations of railway property" that they actually regarded the payment of divi-

21 Hansard, 187: 1588.
22 *Ibid.*
23 Fraser, *British Railways*, 1903, p. 140.
24 See *Railway Times*, May 23, 1868.
25 Hansard, 187: 1588.
26 London *Times*, August 27, 1866.

dend out of capital as a legitimate practice and looked at the chaos of railway accounting as hopeless. Apparently they imagined that they could "eat their cake and have it too." [27] As a natural consequence of this state of affairs, suspicion arose, which proved harmful not only to the public but to the railways as well. As said the *London Times* in 1866,[28] "nothing has damaged railway property so much as the suspicion, notoriously reasonable, that the truth was not put before the public in the reports of railway directors."

The magnitude of the evil due to the lack of confidence could not be fully comprehended at the time. The problem facing the railway companies was not merely to satisfy the shareholders of that time. It was necessary that they should give assurance to the investing public in order to get additional money to keep the railways "alive." Explanations at meetings, statements of figures capable of favorable inference, sometimes sufficed to satisfy those who had already put their money in; but they could not attract new investment.

Following the suspicion of the investing public, the shareholders also became discontented. They saw their property depreciating; they found that their shares could be disposed of only at great sacrifices. No longer were they to be satisfied with "information" alone.[29]

The difficulty, however, was not exactly an economic one. There was plenty of money for investment. It was generally recognized at the time by clearer observers that if there was a single company where shares were considered by its directors to have fallen too low in the market, they could set the matter right easily. There were plenty of shrewd people at the time waiting with money to find investments. "Give them a statement such as they require, and such as any city accountant . . . would prepare, in a form that the simplest tradesman might understand it, and forthwith they will bid within a fraction of the true value of the shares." [30] Thus the problem before Parliament was to stop suspicion and to restore confidence.[31]

[27] London *Times*, November 8, 1867, p. 6.
[28] *Ibid.*, August 27, 1866.
[29] *Economist*, December 28, 1867.
[30] Fraser, *British Railways*, 1903, p. 140.
[31] *Economist*, December 23, 1867.

It was recognized that besides retreating from the costly litigations, in which the railways were fond of indulging, there was only one thing required to set the railways "straight before the public."[32] They must make a clear statement of their affairs. However unpromising it might be, the whole truth must be told so that no disguise or reserve could be suspected. It was urged that[33] there was no cure for the mischief of delusion nor any hope for railway property except by the introduction of a principle of accounting in which nothing should be admitted as profit but surplus of actual receipts over actual expenditures. The Royal Commission on Railways in its report of 1867 also recognized[34] that greater facilities should be afforded for the detection and repression of acts by which the public were misled or deceived. It further said, "The concealment or imperfect representation of important facts, which no one is charged with the duty of faithfully disclosing to the shareholders or the public, will be found to underlie most of the delinquencies . . . and there can be little doubt that many objectionable transactions would not be embarked in if they were to be immediately followed by publicity. . ." A member of Parliament[35] urged before the commission that Parliament should take care to see that the periodical railway accounts should "comprise not only every item of expenditure but every liability, and every contract that they have entered into . . . and leave the public to judge for themselves. Many other members of Parliament were also of the opinion that shareholders should only ask the legislature to require that accounts be kept in an intelligent way so that they may have a chance to "sift them to the bottom."[36]

But it was the report of the commission that gave uniform accounting its proper place of importance.[37] It emphasized that the provisions of the law regarding the financial affairs of railway companies would always remain defective, until a uniform system of accounts was secured. Until that was done, each com-

[32] London *Times*, February 9, 1863, p. 9.

[33] *Ibid.*, November 8, 1867, p. 6.

[34] *Report of Royal Commission on Railways*, 1867, p. xliv.

[35] G. P. Bidder, M. P., before Royal Commission on Railways, 1867. *Evidence before Royal Commission*, p. 803.

[36] Hansard, 191: 1541-1542.

[37] *Report of Royal Commission*, 1867, p. XXIII.

pany was at liberty to adopt its own form of accounts and to vary that form from time to time. The result would always be that no adequate comparison of the financial affairs of different railways, or even of the same railway, could be made. This lack of uniformity in accounting not only deprived the public of the power to ascertain the relative conditions of different companies, but also deprived one company of the means of profiting by the experience of another.

Thus it soon became generally recognized that until clear, complete and truthful accounts, on a common system, could be obtained, there would be continued suspicion. The urgent need of such a uniform system of accounts was recognized, alike, by the railways and Parliament. This was well shown by the fact that while both Houses of Parliament were giving the matter attention, the railway men themselves were holding meetings, in 1868, to discuss the same subject.[38]

To give effect to some of these recommendations, Sir William Hunt introduced the Railway Audit of Accounts Bill early in the session of 1867.[39] In the following year, another bill, called the Joint Stock Companies Accounts Bill, was introduced, the aim of which, similar to that of the bill of the previous year, was to secure to shareholders and the public, periodically, a true balance sheet of the financial affairs of railway companies and a true statement of the assets and liabilities.[40]

Neither of these bills, however, was enacted into law. In the meantime, the government prepared the Regulation of Railways Bill, which embodied many of the principles contained in the two bills just referred to. This bill was first introduced into the House of Lords.[41] A considerable proportion of the bill was based on the recommendations of the Royal Commission.[42] Moreover, the Board of Trade had also received frequent deputations and much correspondence on the subject from railway experts.[43] In fact some of the very fundamental matters, such as the forms

[38] *Railway Times*, May 23, 1868.
[39] For purpose of this bill, see *Railway Times*, June 15, 1867.
[40] Hansard, 187: 1588.
[41] *Ibid.*, 192: 1294.
[42] Hansard, 192: 115-116.
[43] *Ibid.*, 192: 1294.

of accounts, etc., were adopted only after extended consultation with some of the most prominent railway accountants.[44]

When the Regulation of Railways Bill was introduced, the legislators recognized the great change which had taken place in the English railway system since the forties. Thus attention was called to the fact that all legislation connected with railways must be cautious, practical, and well considered, and that in dealing with the subject it was as necessary to look at the interest of the public, on whose behalf the railways were constructed, as it was necessary to take care of the interest of the shareholders who expended their money in those great undertakings.[45] Parliament was also reminded that it was by no means desirable to adopt a policy by which it would lay down stringent rules with respect to all the details of accounts and the management of the companies.[46] It was believed that sufficient time had elapsed since the panic of 1866-1867 to afford Parliament the means of legislating upon the subject without acting in the hasty and ill considered manner which might have been inevitable if they had dealt with it during the previous session.[47] The complete collapse also led the public and the railways to appreciate more fully whatever action might be taken. It was under the influence of such prevailing opinion that the first important act to regulate railway accounts was prepared.

The first part of the bill related to accounts and audit; the second to the liabilities of railway companies in certain cases as general carriers; the third provided for the safety of passengers; the fourth dealt with the matter of compensation for accidents; the fifth had to do with light railways; the sixth referred to arbitrations by the Board of Trade; and the last part was given to miscellaneous matters. "None of these," said the *Economist*,[48] "are unimportant; and all are designed to bring railway law into accordance with recent experience." But the "novel part of the bill is the first section, making new rules for the auditing and inspection of railway accounts." On account of its importance

[44] Hansard, 190: 1957.
[45] *Ibid.*, 190: 1955.
[46] *Ibid.*, 190: 1956.
[47] *Ibid.*, 190: 1956.
[48] *Economist*, March 21, 1868.

and novel nature, that part of the bill, therefore, received much discussion both in and out of Parliament.

During the course of the passage of the bill, Parliament laid great emphasis upon the importance of the forms of accounts which were attached to the bill. It had in mind that the accounts should neither on the one hand be limited to the ordinary payments and receipts, nor on the other hand be so extensive as to make it hard for the eye to follow or the mind to comprehend.[49] They should be sufficiently elastic to meet the varying circumstances of the different railways, and at the same time precise enough to enable shareholders of ordinary intelligence to compare one year's accounts with those of any other year and the accounts of one company with those of another. The guiding purpose was that every person looking at these forms should be able to see at a glance the exact financial position of each company.[50]

The importance of uniformity in railway accounts was greatly emphasized. The advocates of such a uniform system had in mind two important objects: First, to prevent the "dressing" of accounts, and secondly to insure that every item of expenditure should pass through the books of the company. Incidentally, it was also hoped that when all companies adopted the same form of accounts, the public and the investors would be enabled to form some estimate of the values of the shares and securities of railways.[51]

But it was recognized that according to the provisions of the bill, the usefulness of the prescribed uniform system of accounts would largely depend upon the voluntary efforts of the companies themselves. If the companies made use of these prescribed forms, as they should for their own interest, the uniform system would be of great value. The auditors and inspectors would have a convenient guide in the "labyrinth of accounts."[52] The common form would become familiar, and people would know what to verify. One more important and general use of such a common system was that so long as there was no downright falsification, it would be possible to compare one railway

[49] Hansard, 190: 1972.
[50] Hansard, 190: 1957.
[51] *Ibid.*, 191: 1538.
[52] *Economist*, August 29, 1868, p. 993.

with another, and that, where circumstances were nearly similar, the comparison would be invaluable.[53] As a prominent railway accountant said, in the Manchester Railway Conference in 1868, "The importance of the adoption by all railway companies of a clear, complete and uniform system of accounts, properly audited and vouched, can scarcely be over-estimated. . ."[54] It was generally recognized that it was exceedingly desirable to have one form of accounts.[55] In fact all those members of Parliament, who spoke in connection with the bill during its passage, advocated the adoption of a uniform system.

Some contended, however, that it was impossible to have a uniform scheme of accounts for all companies, because the circumstances of the different companies were so dissimilar. A uniform scheme would not furnish any accurate comparison, it was urged, unless people knew what were the gradients of each line and the prices of fuel and labor in each instance as well as other details which varied in different places.[56] This objection, however, failed to gain much weight and experience has since proven that a uniform system is desirable in spite of its drawbacks.

The greatest defect of the bill, however, was said to be the lack of any regulations governing the "filling up" of the uniform forms. It was urged that the usefulness of these forms might be much lessened, if not nullified, by irregularities in the entering of the different expenses into the accounts. Thus the *Economist* said,[57] "We question very much . . . whether the dictation of a certain form in the accounts will do much good. . . There will be room for endless disputes as to whether certain expenses are for renewals or new works, or as to whether capital or revenue should be changed. . ." It also believed[58] that the distrust of the people had been related to the substance of the accounts, and that changing the form would not mend matters much.

The *London Times* also pointed out that "a uniform system of accounts would prevent one line from showing better than an-

[53] *Economist*, August 29, 1868, p. 995.
[54] *Railway Times*, May 23, 1868.
[55] Hansard, 190: 1961-62.
[56] *Ibid.*, 187: 1590-91.
[57] *Economist*, March 21, 1868.
[58] *Ibid.*, August 29, 1868, p. 992.

other, but it would not prevent them all from showing untruly."[59] This paper believed that the people clamored mostly over the evil itself, instead of the source of the evil. "The root of the evil," it said, "lies not so much in the system of accounts, of which every body complains, as in the principle of accounting. . ."[60]

These anticipations, especially that of the *Economist*, have become true since, as shown by the report of the departmental committee on railway accounting and statistical returns of 1909 to be referred to hereafter.

It was also urged that there should have been inserted in the act provisions for a "wear and tear" account. It was believed that the proper way of providing for renewals was to lay aside certain sums annually in proportion to the value of the material and the depreciation it would suffer. This was regarded as being especially important, since the pressure of heavy renewals had been one of the chief factors in tempting railway boards to charge capital with what did not belong to it. In spite of the requirement of the engineers' certificates concerning rolling stock and permanent ways as provided by the bill, some railway men thought that it would be impossible to ascertain the real surplus profit to be divided as dividends without a depreciation account.[61]

Furthermore, there were also other persons who were entirely opposed to any such regulation of accounting. They based their opposition chiefly on the ground that England "had grown great by having private parties to manage their own affairs in their own way — by individual care of individual interest which could not be superseded by the action of any government department whatever."[62] The *Railway Times*,[63] which was strongly opposed to the measure, said, "The entire railway history of the kingdom is redolent of the idea as well as of the practice of shareholders being at all times and under all circumstances fully cognizant of any matter or detail in which their property may be involved." After citing the satisfactory results of several of the companies

[59] London *Times*, November 8, 1867, p. 6.
[60] *Ibid.*, November 6, 1867, p. 6.
[61] See *Economist*, August 29, 1868, p. 993.
[62] See Hansard, 167: 1569.
[63] *Railway Times*, June 8, 1867.

who had been left to manage their accounts in their own way, the paper concluded that "all these private parties have been conducting their own affairs in their own way; and is not to be endured that they should be interfered with. . ."

Furthermore, in the debate in Parliament, it was also agreed that it was quite impossible to control railway directors by acts of Parliament. If they were determined to "cook" the accounts, they would do so, in spite of all the acts in the statute book.[64]

Another important provision of the bill was that regarding the penalty for falsifying accounts. This question did not receive so wide discussion as that concerning the accounts themselves but it excited more animated debate in Parliament than any other part of the bill. The original bill provided that "if any statement of accounts, balance sheet, estimate or report, which is required by this act is false in any particular, the auditor or officer of the company who signed the same shall, unless he satisfies the court that tries the case that he was ignorant of such falseness, be liable, on conviction thereof on indictment, to fine or imprisonment, or on summary conviction thereof to a penalty not exceeding fifty pounds." [65]

The most striking feature of this provision was that the onus of proof was placed on the defendant. This at once aroused intense opposition. The beneficial effect of punishing the wilful falsification of railway accounts was generally admitted; but the manner of inflicting such punishments as provided by the clause proved extremely distasteful to many. The provision was strongly opposed because it was entirely contrary to ordinary principles of law. According to usage, a man was assumed to be innocent until he was proven guilty, while according to the provision in the bill, the railway officers were to be held guilty until they could establish their innocence. According to this principle, it was feared that if there was any falsehood in any of the accounts, statements, balance sheets, etc., so voluminously required by the bill, and which the chairman and secretary were required to sign, they would be held guilty and might be sent to jail unless they could prove their ignorance of the falsity. Nor were railway officers to be allowed the ordinary privilege of trial

[64] See Hansard, 191, p. 1540.

[65] *Railway Times*, March 21, 1868.

by jury like other Englishmen, but they must prove their ignorance to the satisfaction of the court trying the case. It was urged that this system would be liable to be attended with great oppression, to say nothing of the violation of all established customs. The judges, in spite of their ability and the respect of the people for them, were not immune from errors. In occasional instances, they might also have a grudge against railway officials. Therefore it would be necessary, it was contended, to appoint railway officers who know nothing of the accounts so that they might be able to prove their ignorance and could sign the required documents without danger of being imprisoned or fined.[66] If these disgraceful penalties were to be attached to the ordinary performance of the duties of a railway officer, it would become impossible to find any respectable people to perform such duties.

The *Economist* also questioned the practicability of the provision, not only because the provision was contrary to the ordinary practice of law but because it was illusory. It called attention to the fact that particular falsities were as likely to creep into accounts by neglect as by wilful perversion. Therefore it believed that the clause, as it stood, instead of doing any good to insure true accounts would offer a premium on being neglectful and ignorant.[67]

Ultimately, the heated discussion resulted in the amendment of the penalty clause so as to read:[68]

> "If any statement, balance sheet, estimate, or report which is required by this act be false in any particular to the knowledge of the auditor or officer of the company who signs the same for the company, such officer or auditor shall be liable upon conviction thereof on indictment, to fine or imprisonment."

Thus the onus of proof was removed from the defendant; and railway officers were to be punished for signing statements and accounts which they knew to be false.

The bill when first introduced was quite a voluminous document but it was found, on close examination, that many of the provisions, though admirable in theory, were impracticable. Accordingly, it was greatly reduced in size before it reached the second reading in the House of Lords, so as to make it a smaller

[66] Hansard, 192: 6-7 and 190: 1962.
[67] *Economist*, March 21, 1868.
[68] Hansard, 192: 7-8.

and more practicable measure. After various modifications and improvements, the bill received the royal assent on July 31, 1868, and became the Regulation of Railways Act of that year.[69]

Fifteen schedules or forms were prescribed, a great part of which relate to accounts, while the others deal with statistics of traffic, mileage, etc. They include, in the first place, a set of capital accounts. No. 1 is a statement of capital authorized and created by the company, requiring the enumeration in detail of the acts or certificates of the Board of Trade, authorizing the creation of capital, and a statement in each case of the amount actually created and the balance left. No. 2 is a statement of stock and share capital created showing the proportion received, and requires the exhibition in parallel columns of the amount of capital created under each act or certificate, the amount received, calls in arrear, amount uncalled and amount unissued. No. 3 shows the capital raised by loans and debenture stock, and the amount of each at the beginning and end of the half year compared. These are, however, subsidiary to Nos. 4 and 5, the object of which is to show at a glance how the capital account stands and what has been done upon it during the half year, especially how the money has been spent. The statements are quite detailed, and "shareholders and all concerned should be able to tell," it was expected, "at a glance whether there is any item here properly belonging to revenue."[70] No. 6 is a return of the working stock, which was regarded as of great importance in connection with the engineers' certificate which must be affixed to the accounts.[71] The object of Nos. 7 and 8 is to show in detail the proposed further expenditures on capital account in the following half year and subsequent years. A comparison of the proposed expenditures compared with the available assets of the company was expected to be of great value. The need of such an account had been insisted upon for some years and its usefulness was well recognized. It was, however, pointed out at the time as a defect that the directors were in no way bound

[69] 31 and 32 V. c. 119.

[70] *Economist*, August 29, 1868.

[71] The engineer and the locomotive superintendent were required to certify, respectively, that the company's permanent way, stations, etc., and the company's plant, engines, etc., were maintained in good working condition and repair during the half year.

by their estimates even as to the half year concerned; but it was hoped that this would be safeguarded by the fact that the ensuing account would show whether or not the estimates were correct, although the remedy would be only *ex post facto*.

Nos. 9, 10 and 11 are revenue accounts. The first deals with the gross revenue, the second the net revenue, and the last, the appropriation of the balance, if any, available for dividends. Supplementary to No. 9 is No. 12, which consists of abstracts A. B. C. etc., referred to in No. 9. Those abstracts were expected to prove especially useful in enabling the shareholder to study his own company's affairs and compare its expenditures with that of others. Form No. 13 is the general balance sheet, which exhibits the whole system. Statistical forms to show mileage statements and those to be used by the company's engineers and locomotive superintendents were also prescribed.

These prescribed accounts may be conveniently classified into two groups: those relating to capital and those relating to revenue. According to this system, the receipts and expenditures on capital account are shown separately from the general balance sheet, which differs materially from the American system where the balance sheet exhibits in condensed form all the assets and liabilities of the company, and the income statement shows the gross earnings and expenses as well as the net revenue and its application. This distinctive feature of British railway accounts is sometimes known as the "double account system," according to which the details of capital expenditures and capital receipts are separated from the other assets and liabilities. Only the balance, either positive or negative, enters into the general balance sheet. This system is based on the theory that inasmuch as the capital is created by Parliament for a specific purpose, that purpose is best fulfilled by crediting to one special account all amounts received from the issue of capital securities and debiting the account with all the assets acquired with the funds so received.[72]

According to the provisions of the act every incorporated company, seven days at least before each ordinary half-yearly meet-

[72] *Cf.* an able article by A. M. Sakolski on the "Control of Railroad Accounts in leading European countries," in the *Quarterly Journal of Economics*, May, 1910.

ing, should prepare and print, according to the statutory forms, a statement of accounts and balance sheet for the preceding half year and an estimate of the proposed capital expenditure for the ensuing half year, which should be the same as those submitted to its auditors. In case of default, the company should be liable to a fine of five pounds per day. The Board of Trade, with the consent of a company, was authorized to alter the statutory forms to suit special circumstances.

The act further required that every statement of accounts, balance sheets, etc., required by the act, should be signed by the chairman or deputy chairman of the company's directors and should be preserved at the company's principal office. A printed copy was required to be forwarded to the Board of Trade. Shareholders and holders of debentures, etc., were also entitled to receive copies of such accounts on application. However, all persons interested in the company's affairs were permitted to peruse the original copy without charge. When a company should act in contravention of these provisions, it would be liable to a penalty not exceeding fifty pounds for each offense.

Upon the enactment of the act, the *Railway Times* expressed much dissatisfaction over the whole measure,[73] and several members of Parliament also regarded the act as being too weak to be of much value.[74] More than anything else, the means for securing the object of the act was severely criticised. Dissatisfaction was especially expressed at the purely permissive character of the requirements. The only compulsory clause was that requiring the publication of the accounts in a certain form. Even this compulsory provision was regarded as weak. A maximum penalty of £35 per week was regarded as being ineffective to give any great stimulus to exertion, at least in the case of important companies where a body of directors at any time had much to gain by a stealthy evasion of the act. Much mischief might be done long before it could become worth while to prevent the accumulating penalties.[75]

On the other hand, the *Economist* at once recognized the prescribed accounts as being very "skillfully framed." After ex-

[73] *Railway Times*, August 1, 1868.
[74] Hansard, 190, p. 1968.
[75] *Economist*, March 21, 1868.

amining and criticising every feature, it concluded that "the accounts are very perfect and likely to be useful, in spite of all defects." [76]

It was further recognized that the silent influence of the provisions would have a great amount of influence in preventing companies from violating these regulations. The fact that a departure from the prescribed forms would at once expose a defaulting company to the penalty of discredit, which would be much severer than a fine, would insure at least a nominal compliance with the provisions.[77]

The Regulations of Railways Act, 1868, closed the legislation on railway accounting. The regulations governing, and the forms of accounts adopted in that year were generally recognized as being very good in themselves. They emphasize the advanced ideas which English legislators entertained long before others realized the importance of this branch of railway regulation. But they went no further. Instead of following up its good start and taking advantage of its subsequent experience to improve these regulations and principles as courageously as it had adopted them, England settled down for many years to the idea that nothing further was needed. Thus many defects in these regulations have been suffered to exist during the last forty years.

Among these defects, first of all, may be mentioned the fact that there seemed to be much variation in the date of closing the financial year of some of the companies. This defect, though apparently of little consequence, had the undesirable effect, as pointed out by the departmental committee on railway accounts and statistics of 1909,[78] of rendering comparisons less valuable than they would have been if the same date were common to all companies.

Then the established regulations required that railway companies should prepare their accounts in accordance with the forms prescribed in the act of 1868 half-yearly is not in accord-

[76] *Ibid.*, Aug. 29, 1868.

[77] *Economist*, March 21, 1868.

[78] *Report of the Committee of the Board of Trade on Railway Accounts and Statistical Returns*, 1909 (hereafter called report of departmental committee on accounts and statistics, 1909), p. 4.

ance with the usual practice of other companies and does not seem necessary according to expert opinion.[79]

But another defect, which is of much greater consequence, lies in the lack of uniformity in practice. "It is obviously of the first importance," said the departmental committee on railway accounts and statistics, 1909,[80] "from the point of view of comparison between the different companies, that there should be uniformity of practice among all the companies with regard to the keeping of accounts and statistics; that is to say, that every heading both in accounts and in the statistics, should bear precisely the same meaning in the case of all railways — should, in fact, be standardized." In this connection it may be recalled that one of the leading purposes for enacting the act of 1868 was to afford the means of a comprehensive comparison between the different companies, and that it was emphasized at the time that uniformity in practice was even more important than uniformity in the system of accounts.

In practice, however, the emphasis seems to have been placed in the wrong place. The forms of accounts themselves are uniform, but the manner in which these accounts are filled up differs among the different companies. Thus after reviewing the diverse nature of the capital accounts of some sixteen leading railways, the *Economist* [81] in 1882 stated that "it would appear to be wholly impossible to construct a statement, setting forth the actual money expenditure upon those systems — in many cases it would be difficult even for the companies themselves to construct such a statement." This financial paper further stated that the capital accounts of railway companies "were wholly unreliable for purposes of contrast with revenue, almost every company constructing its capital account upon a different principle." An English writer [82] also stated that "the first item of every railway balance sheet, which has yet been published to the world under state authority during the past seventy years, is the deliberate expression of an unmitigated falsehood. . . In ar-

[79] *Report of departmental committee on railway accounts and statistics*, 1909, p. 4.

[80] *Ibid.*, p. 5.

[81] *Economist*, March 4, 1882, .pp 248-249.

[82] Fraser, *British Railways*, 1903, pp. 138-139.

riving at each of these balances, every conceivable irregularity . . . has been introduced, and has thereby received, not only the sanction but the approval of the state." This writer further said that "the account is not a balance sheet at all, nor is it even a very defective shadow or skeleton of one. It is . . . only the declaration of an untruth, in every instance, coupled with a list of a few of the most insignificant balances, which appear in a company's set of subsidiary book of accounts."

We are not prepared to agree with these strong terms. But the lack of uniformity in practice has recently attracted considerable attention. The departmental committee on railway accounts and statistics, 1909, gave much time to this difficulty, and the evidence taken by that committee goes to show that much needs to be done in making the uniform accounts really as useful as they should be. Indeed, this committee was convinced that unless some permanent machinery is established to define the scope of the various headings and to decide authoritatively from time to time the questions of detail which must arise in this connection, much of the value of the uniform system of accounts would be lost; and they accordingly recommended the formation of a standing committee, to be appointed by the Board of Trade, which should include representatives of the railway companies, to decide on points arising in connection with the preparation of the accounts and statistical returns.[83]

This departmental committee also recommended that "in the interest both of the railway companies themselves and of the general public" a system of yearly accounts and statistical returns should be substituted for the present system of half-yearly accounts. It further recommended that a uniform date should be adopted to close the financial year of all the companies, instead of permitting each company to adopt its individual date.

Furthermore, this committee took great pains in preparing a set of forms for financial accounts and returns,[84] with the aim of meeting the changed circumstances. Special effort was made

[83] For this and other recommendations of this departmental committee, see its report, pp. 1-6.

[84] Those interested in railway accounting will find their time well spent in examining the forms which are to be found in appendix I of the committee's report.

to exclude from the financial statements all matters of a purely statistical nature, thus making a strict division between the financial and statistical parts of the returns which did not exist in the statutory forms then in force.

A bill was introduced into the House of Commons in 1910, to give effect to most of the recommendations made in the report of this departmental committee, but was withdrawn in consequence of the dissolution of Parliament.

From the foregoing, we have seen that England endeavored to regulate the accounts of railways, to some extent, from the beginning, but prior to 1868, the companies were practically free to keep their accounts in their own way. The panic of 1867 and other events led Parliament to adopt a definite and uniform system of accounts twenty years before the United States attempted to regulate railway accounting in any definite way. England, however, made no further progress after her early start. Between 1868 and 1909 nothing was done to improve the old system, whose defects are many and obvious. During this time the United States made some remarkable advancements in railway accounting and its regulation. The measures adopted by the Interstate Commerce Commission toward the unification of railway accounting and statistical returns, which met with considerable opposition at first, are gradually becoming more popular and have unquestionably done much good. In fact the report and recommendations of the departmental committee of 1909 have been greatly influenced by the system of accounts adopted by the Interstate Commerce Commission. It is hoped that Parliament may soon see fit to give more serious consideration to these recommendations.

Since writing the foregoing, the Railway Companies (Accounts and Returns) Act of 1911 has been enacted. This act is based largely upon the recommendations of the departmental committee of 1909.

At a glance, one can see that the act and its forms of accounts are a decided improvement over that of 1888. The half-yearly accounts are changed into annual accounts, which experience has unquestionably proven to be the right thing. The forms are much more detailed and precise than the former ones. This is

especially true with regard to the revenue accounts. The introduction of the appropriation account is a decided improvement. The separation of the various expenses of operation and maintenance according to their nature are incomparably more distinct and detailed than those of 1886.

Another notable improvement is the equalization of the receipts and expenses of the different auxiliary operations. These auxiliary operations are of an entirely different nature from that of the general railway business. Chief among this may be mentioned form No. 11 which shows the receipts and expenses in respect of omnibuses and other passenger vehicles not running on the railway, No. 12, receipts and expenses in respect of steamboats, No. 15, receipts and expenses in respect of hotels, and of refreshment rooms and cars where catering is carried on by the companies. Each of these forms a distinct auxiliary service of its own kind and each service has its own head and staff. To separating the receipts and expenses of each service from those of the rest, not only the general manager of the whole undertaking may be better enabled to watch the whole situation and measure the efficiency of his men, but the individual heads of the different services will also be impressed more effectively with their responsibility. By separating the accounts of the different services and allocating the items of revenues and expenses to the respective officers responsible for the items, the company will do much to encourage economy and efficiency. With the same idea in view, wages are separated from costs of materials and office expenses. With the multiplication of the activities of a modern railway, such a system of segregation is imperative to successful management.

We must observe, however, that improved as it was, the act still has many defects which, in our opinion, could be advantageously avoided. First of all it may be mentioned that the leave given to end the financial year other than on the same date is not going to prove advantageous. To close the accounts on the same date is of fundamental importance to realize fully the advantages of a uniform system of accounts, which was one of the chief reasons for passing the bill. In any act, loopholes or exceptions to the general rule can hardly be expected to do more good than evil.

Another defect, which we feel is a serious one, is the lack of any definite and detailed classification of the different items of accounts. It may be recalled that one of the chief aims of the departmental committee of 1909 was to secure uniformity. But we may be permitted to say that uniformity in accounting can not be easily achieved. The uniformity in the headings of accounts cannot be expected to insure the uniformity in what may be put under each heading by the different railways. While the accountants may be reasonably expected to put the most obvious items under the proper heads of accounts, they may quite as reasonably be expected to interpret the less obvious items — of which there are numerous in the enterprises of a railway — in different ways. To sustain this statement, it may be recalled that the Regulation of Railway Act, 1868, prescribed a form of accounts for all railways, yet at the time of the revision in 1913, following the act of 1911, there were innumerable differences between the accounts of one company and those of another. Although the present forms of accounts are far more detailed and specific than those of former years, there is nevertheless ample room for differences in the allocations. It is understood that the Standing Committee of Accountants, under the Railway Clearing House regulations, has prepared an annotated form of accounts, but it is not generally accessible to the shareholder or the general public. This, in the opinion of the writer, is a defect. The said annotated classifications or something similar to it should be prepared and promulgated by government authority which should be strictly followed by the railways and accessible to all interested parties, instead of keeping it under the veil of secrecy. Publicity and openness is the foundation of public confidence. Therefore it is publicity that government regulation should emphasize. In the long run, the railways and all other parties concerned will have everything to gain and little to lose by adopting such a policy of publicity. There seems to be considerable apprehension against such an open policy, but we feel the anticipated dangers are visionary rather than real. Given a fair trial, publicity will surely find its own favorable position in railway finance and regulation.

The above is only an inadequate observation. To give full consideration to the act would require at least a separate chap-

ter. As the act was passed after this monograph was written, the writer prefers to limit himself to this short analysis. It is recommended that every student interested in accounting will find it of great advantage to make a thorough examination and detailed comparison of the different forms of accounts as set forth in the accounts of 1886 and 1911.

CHAPTER VIII

STATE AUDITING AND INSPECTION

Parliament has required from the beginning an authentic audit of railway accounts by the railway companies themselves. It has also adopted elaborate, although ineffective, regulations governing such auditing by the companies. Thus in the Companies Clauses Act, 1845, numerous provisions were made governing the appointment and duties of auditors, etc.[1] The substance of these rules may be briefly summed up as follows:

Unless otherwise provided by the company's special act, the shareholders at the first meeting after the incorporation of the company should elect, either in person or by proxy, the prescribed number of auditors,[2] in like manner as in the case of the election of the directors. One of the auditors, to be determined in the first instance by ballot between themselves or in any other way suitable to themselves and afterwards by seniority, should retire at the end of the first ordinary meeting in each year;[3] and this annual vacancy should be filled by election at the same meeting. If no other qualifications were required by the special act, every auditor should have at least one share in the undertaking, and should not hold any other office in the company nor should he "be in any other manner interested in its concerns, except as a shareholder."

In regard to the duties and powers, the act stipulated that the auditors should receive and examine all the half-yearly or other periodical accounts and balance sheets of the company, which should be delivered to them by the directors at least fourteen days before the ensuing ordinary meeting at which these accounts, etc., were to be produced to the shareholders. They were also required either to make a special report or simply to con-

[1] 8 V. c. 16, ss. 101-108.

[2] If no number is prescribed, then two would be the number.

[3] Each auditor should be immediately eligible to reëlection.

firm the accounts, etc., submitted. Furthermore, these reports or confirmations together with the reports of the directors should be read at the meeting. In performing their duties, the auditors were empowered to employ at the company's expense such accountants and other persons as they might deem proper.

After the financial disaster of 1847, general proposals concerning the auditing of railway accounts were made, but no result was obtained from these attempts. In 1848 a bill was sent down from the upper house of Parliament, in which it was proposed that on the requisition of a certain number of shareholders who were ready to deposit £200 to meet the expense, the government should appoint impartial persons as auditors. The principal object of the bill was to protect the minority. It was urged that as the directors were elected by majority, if the auditors were also elected by the same majority, the check would be imperfect.[4] This measure was opposed however, on the ground that there was no demand for it by railway shareholders, that it is very questionable whether Parliament had any right to interfere with private business, and that one might just as well have an audit of the accounts of the Bank of England.[5] After considerable discussion in the House of Commons, it was finally rejected.

But the financial difficulties of the railways were too apparent to escape the attention of Parliament. A select committee was appointed by the House of Lords in 1849 to consider "Whether the railway Acts do not require amendment, with a view of providing for a more effectual system — audit accounts, to guard against the application of funds as such companies to purposes for which they were not subscribed, under the authority of the legislature."[6] This committee recommended that the right of inspection by shareholders of the accounts should be unrestrained: that all account, without exception, touching or relating to the receipts or payment of the company should be required to be produced; and that in case of refusal the statutory penalty should be extended from the bookkeeper to the governing body. The committee further recommended that the restriction upon

[4] Hansard, 98: 1143-1147.

[5] Hansard, 187: 1589-1590.

[6] *Report of Royal Commission on Railways*, 1867, p. xviii.

selecting auditors from among the shareholders should be repealed, and that the auditors should be empowered to call for all books and documents of the company necessary to elucidate not only the balance sheet, but the entire whole financial condition of the company. Moreover, the committee also urged that the government should name one auditor to act in conjunction with two auditors to be named by the company; and that if the government auditor differed in opinion from the company's auditors, his opinion should be recorded and published with the accounts for the information of the shareholders.

Bills embodying some of these provisions were introduced into Parliament in subsequent sessions, but none of them became law until 1868.

In 1851 the railway companies themselves brought in an audit bill, proposing to appoint a board of auditors elected by shareholders. The president of the Board of Trade objected to the proposal, on the ground that it would make the people judges in their own case and that such a tribunal lack independence and continuity. The last proposal made to the House of Commons up to 1867 was that the railway companies should elect a body of 300 persons, out of which five auditors should be chosen to hold their places during good behavior. It was proposed that the debenture holders should also take part in the election. No legislation, however, sprang from these bills.[7]

Thus up to 1857 the main objects aimed to be secured by Parliamentary action may be summed up as follows:[8]

(1) A clear and faithful record and account of all the financial transaction of the company.

(2) Authority for shareholders to inspect within certain fixed periods the company's accounts and to take copies or extracts.

(3) The appointment of auditors from among the shareholders to audit the balance sheets and accounts.

(4) The preparations of a scheme for the declaration of a dividend to be paid out of the profits of the company.

For the purpose of securing these objects, Parliament adopted the following rules.

Each company at its annual meeting should appoint two audi-

[7] Hansard, 187: 1589-1590.

[8] *Report of Royal Commission on Railways*, 1867, p. xliv.

tors, one of whom should retire annually but should be re-eligible.

The directors should deliver to the auditor half-yearly or other periodical accounts and balance sheets fourteen days before the meeting at which they were to be produced.

The auditors should receive and examine the same, and might employ at the expense of the company such accountants and other persons as they might think fit to assist them. They should either make a special report on the accounts or simply confirm them.

The directors should keep the accounts of the company. The books should be balanced at the principal periods, and thereupon the exact balance sheet be made up, which should exhibit a true statement of the capital stock, credits, and property of every description belonging to the company, the debts due by the company, as well as a distinct view of the profit or loss which had arisen in the course of the half year.[9]

The application of these provisions, however, was by no means free from difficulty. In practice, it was found that only a very short summary was usually laid before the auditors, who made an examination of it within a very limited time.[10] The daily transactions of railway companies were so numerous and intricate that the company was compelled to employ a staff of clerks and accountants proportionate to the magnitude of its business in order to examine and check every transaction as it took place. Since the manner in which every transaction was debited or credited depended upon the orders issued at the time when the transaction was made, the accounts could be checked efficiently only by a contemporaneous audit by an establishment employed in the same office, or by a complete transfer or transcript of the accounts, vouchers, correspondence, minute books, etc., to be examined elsewhere.[11] It was quite competent for the shareholders of any company to direct their auditors to investigate the accounts of the company to any extent they thought necessary after the accounts were rendered each half-

[9] *Report of Royal Commission on Railways*, 1867, p. xliv.
[10] *Economist*, May 16, 1857.
[11] *Ibid.*

year, but it did not seem to be within their power to direct any continuous, daily audit.

The Royal Commission on Railways, 1865-67, however, discovered that in many cases, especially as in that of the London and North-Western,[12] much could be done by the companies themselves for the purpose of ensuring a supervision and effective audit in the interest of the shareholders. At the same time, the commission pointed out that the powers conferred by the Companies' Clauses Acts were manifestly insufficient for this purpose, in case the directors were otherwise disposed.[13]

It has been shown in a previous chapter that under the system of independent auditing much abuse arose, especially in the declaration of dividends otherwise than out of net profits. It was a "striking fact," said the *London Times*,[14] "that . . . the auditors have never discovered or, at any rate, disclosed any one of the numerous cases of . . . false returns to the Board of Trade, payments of unearned dividends, charging of revenue expenses to capital, or any other of the various forms of 'cooking' accounts by which shareholders have been lured to ruin. . ."

Therefore it was again urged that no legislation to repress the existing abuses would be of any avail without a system of government audit of the companies' accounts.[15] On the other hand the Royal Commission apprehended that it would not be desirable to impose upon the Crown the duty of auditing the accounts of joint stock companies and to certify to the shareholders the correctness of their own balance sheets, for in practice this would require a very large staff of officers as well as involve very serious responsibility, merely to relieve the shareholders of a duty which they could well perform for themselves by the election of competent auditors with adequate powers and sufficient remuneration. But this commission agreed with the select committee of 1849 that the restriction upon selecting auditors from among the shareholders should be repealed, and was also of the opinion that the auditors should be empowered to carry on a

12 *Royal Commission on Railways*, 1865-74, Appendixes E-F.

13 *Ibid.*, 1867, p. xlv.

14 London *Times*, November 3, 1867, p. 4.

15 *Report of Royal Commission on Railways*, 1867, p. xliv.

continuous audit and to call for all books and documents necessary to elucidate not only the balance sheet, but the whole financial position of the company.[16]

In commenting on the report of the Royal Commission regarding government audit of railway accounts, the *Economist* stated,[17] "These remarks seem to us full of wisdom. The attempt to separate the *accountant* from the *transactor* will fail, unless pursued into the minutest details. The man who does the business will give what accounts of it he pleases."

The general chaotic condition of railway finance which has been repeatedly referred to and the recommendations of the Royal Commission led Parliament to insert a clause in the Railway Companies Act, 1867,[18] giving to the shareholders a control through the auditors, and imposing on the auditors a responsibility which they never had before. This clause provided, as briefly stated in a previous chapter, that no dividend should be declared by a company until the auditors had certified that the half-yearly accounts contained a full and true statement of the financial condition of the company, and that the proposed dividend was *bona fide* due after charging the revenue of the half-yearly with all expenses which might be paid out of such revenue in the opinion of the auditors. The auditors were empowered to examine the books of the company at all reasonable times, and to call for such further accounts, vouchers, papers, etc., as they saw fit. They were also empowered to refuse to certify any accounts or statements of the company until the directors and officers of the company had produced the required accounts and given their assistance as far as they could. Furthermore, the auditors might at any time add anything to their certificates or issue to the shareholders independently at the expense of the company, any statement respecting the financial condition and prospects of the company which they thought important for the information of the shareholders.

Under the existing circumstances when every imaginable mystification was thrown over the declaration of dividends, when auditors never disclosed any of the numerous serious irregular-

[16] *Ibid.*, 1867, p. xlv.
[17] *Economist*, May 18, 1867.
[18] 30 & 31 V. c. 127, s. 30.

ities, and when general confusion seemed to hang over the financial affairs of the whole system, it was natural that the clause was highly valued at the time of its passage. It was expected, not without reason, that henceforth the auditors would no longer have any excuse, when actions were brought against them for neglect of duty.[19]

So far so good. But in the act a further provision, as referred to before,[20] was made to the effect that in the declaration of dividends and auditing of accounts, if the directors differed from the judgment of the auditors with respect to the payment of any expenses of the company, such difference should, "*if the directors desire it*,"[21] be stated in the report to the shareholders, "and the company in general meeting may decide thereon, subject to all the provisions of the law then existing, and such decision shall for the purpose of the dividend be final and binding." This provision proved to be a loop-hole through which the expected usefulness of the system of auditing, as shown in a previous chapter, was practically nullified. . .

As the systems of auditing adopted in 1845 and 1867 both failed to be effective enough to restore confidence, it was suggested that a committee of investigation might be effective in settling the existing difficulties. But it was at once comprehended that the nature and composition of such committees of railway companies would prevent them from doing anything effective. They could be composed in all kinds of ways, they could lay down every species of doctrine, and they could accept as well as deny all sorts of statements. The investigation of railway affairs was recognized as a difficult task even for an expert, and the task wholly surpassed the power of any untrained man.[22]

Moreover, experience had taught that a committee of investigation was almost never both able and impartial. All the competent people in a railway company, it was told, took a side either for the directors or against them, and they would go into the committee with a bias in their minds. Thus, in practice, the

[19] London *Times*, November 13, 1867, p. 4.

[20] *Cf. supra*, p. 216.

[21] Italics are mine.

[22] *Economist*, December 21, 1867.

reports of committees of investigation were either questioned or denied. They often would "not settle so much as they unsettle. . .," and they would "only add a new disputant and a new set of contested figures" to the controversy.[23]

Therefore, it appeared that the true remedy for the lack of confidence was an independent audit of all the railway accounts.[24] The government was urged to exercise what philosophers called the "function of verification." The railways, by which alone people could travel and traffic could be conveyed, were regarded not only of sufficient magnitude to justify the action of the government, but so important that the state would be to blame if it did not act. The government was held as the only uniform authenicator possible — the only one which could apply the same measure with the same weight to all railways in the country. The shareholders themselves were reported to be desirous of having a system of government audit and were ready to share the expenses. "An optional audit of petitioning railways is," said the *Economist*,[25] "both on grounds of theory and reasons of practice, the sole outlet from the existing difficulty." In fact, during the early part of 1867 several proposals were presented to the Board of Trade, which, though varying much in detail, contained the common recommendation that an auditor should be appointed by that department to audit railway accounts.[26] Consequently in the Regulation of Railways Bill of 1868, provisions were made for a more effective system of auditing and inspection. When the bill was introduced, it was generally conceded that a system of government audit of railway accounts would do much toward restoring confidence. But it was also recognized that in this very matter of restoring confidence lay the danger of the system. The public might place too much faith in the system. They might be led to believe that the soundness of a company's proceedings and finance were certified and even guaranteed by the government. Again it was recognized that it was by no means an easy work for the government to audit efficiently and effectively the accounts of the

[23] *Ibid.*, December 28, 1867.
[24] *Ibid.*,
[25] *Economist*, December 21, 1867.
[26] Hansard, 187: 1590.

railway companies. An audit of business "from without" must be such as would be of avail against directors who desired to deceive. The details which auditors in such cases would have to look into and the minuteness of the evidence they would have to inspect, it was urged, could hardly be properly appreciated by any but those who had practical experience in such matters.[27]

On account of the possible dangers and the great difficulties which might arise from a system of government audit, it was suggested that railways themselves might constitute a central board of audit, and that they might for that purpose make use of the existing machinery of the Railway Clearing House.[28] Such a board under the control of the railways themselves, it was believed, would be less likely to give false security than an audit under the government.[29]

The most important question which arose during the discussion, however, was that as to what should be the scope of the audit. An ordinary audit, such as the mere comparison of payments and vouchers, was an operation which did not give the protection which shareholders sometimes fancied it did. On the other hand it did not appear politic to interfere too much with the policy of railway companies. If the government should give guarantee to all the railway accounts presented to the Board of Trade, the various companies of other pursuit might make similar demands.[30]

After much debate, provisions were made, in the act of 1868, to repeal the restriction imposed by the Companies Clauses Act, 1845, that auditors should be shareholders, for the reason that it had proven desirable in some cases to have independent auditors who should be entirely unconnected with the company.[31]

But what was entirely new and of great importance was the provision for the appointment of auditors by the Board of Trade. According to this provision, the Board of Trade, upon application made in pursuance of a resolution passed at a meeting of the directors or at a general meeting of the company,

[27] *Economist*, May 18, 1867.

[28] Sir Geo. Findlay's book on the *Working and Management of an English Railway* has an excellent treatment of the Clearing House.

[29] Hansard, 187: 1591.

[30] *Ibid.*, 191: 1538.

[31] Hansard, 190: 1858.

might appoint an auditor in addition to the two auditors of the applying company, and such government auditors were to be paid, by the applying company, a reasonable remuneration prescribed by the Board of Trade. The government auditor was to have the same duties and powers as the companies' auditors; and the company might declare a dividend only when the majority of these three auditors had certified that such dividend was properly earned according to the rules laid down in section 30 of the Railway Companies, 1867.

It was regretted, however, that the act provided for only one government auditor in each case where the company had two. As a majority was to decide when a dividend might be declared, it was apprehended that the official auditor might be overruled. Then he would only have the liberty, according to the act, of printing his protest at the expense of the company. Even admitting that the possibility of such a protest would be an obstacle in the way of improper dividends and that the government auditor might receive more consideration than those of the company, nevertheless it remained a fact there were many disputes in which the shareholders and the capitalists might be indisposed to give the government auditor their proper support.[32]

It was also urged both in and out of Parliament [33] that auditing alone was not sufficient to prevent disorders in railway finance, for frequently the books of unreliable companies were well kept. The root of the evil was in the charging of the various items in the books.

Another important provision contained in the Railway Regulation Act of 1868 was that in case there were any difference of opinion between the auditors, then it should be imperative, instead of permissive, as was originally provided in the bill, that the dissenting auditor should issue to the shareholders, at the cost of the company, a statement containing the grounds on which he differed from his colleagues and prepare such other statements respecting the financial conditions and prospects of the company which he deemed material for the information of the shareholders.[34]

[32] *Economist*, March 21, 1868.

[33] Hansard, 190: 1960, and London *Times*, November 22, 1867, p. 6.

[34] Hansard, 190: 1962.

To strengthen the position of the securities-holders, the act further provided [35] that the directors, or two-fifths of the holders of shares, stocks, or preference shares, or half of the creditors, might apply to the Board of Trade to appoint inspectors to examine a company's affairs, in case they produced evidence to satisfy the Board of Trade. In so applying to the Board of Trade the applicants, however, were required to meet all expenses incurred in connection with the inspection, unless the Board of Trade should direct the same or any portion thereof to be borne by the company, and they might also be required to give security for the payment of such expenses.

The government inspectors were empowered to examine all the company's books, documents, etc., as well as to administer oath; and the directors, officers and agents of the company were required to produce, for the examination of the government inspection, all such books and documents. The latter were also required under penalty [36] to render to the government inspectors all reasonable facilities for discharging his duty.

Upon the conclusion of the examination, the inspectors were to report their opinion both to the Board of Trade and the company, the latter being required to print and deliver a copy of the same to the Board of Trade as well as to every applicant who held any securities of the company.

Furthermore, the companies were authorized to appoint, on their own accord, at any extraordinary meeting inspectors for the purpose of examining into the company's affairs, and such inspectors of the company were to have the same powers and to perform the same duties as those appointed by the Board of Trade.

This system of inspection was adopted for the purpose of helping the shareholders to bring into their proper light without involving the assumption of any serious responsibility by the government.[37] Such inspection of private business did not establish any new principles, as a similar system had been intro-

[35] 31 & 32 V. c. 119, ss. 6-10.

[36] In case any director, officer, or agent of the company should refuse to produce any books or documents, or to deny the facilities necessary for the inspection, he should be held liable to a penalty of £5 for every day during which the refusal continued. See sections 8 & 10, 31 & 32 V. c. 119.

[37] Hansard, 190: 1958.

duced by the Companies Act of 1862, in the case of ordinary joint stock companies.[38]

The defect of this system of government inspection, as was pointed out at the time,[39] was that the inspection was contemplated only in extreme cases. The limitations placed upon the application for government inspection were said to be too cumbersome. It was urged that since the applicants were required to give security for the cost of any government inspection, Parliament could have well afforded to require the consent of a smaller proportion of the shares or debentures of a company for any inspection.[40] It would be almost impossible to make any such inspection if a directorate objected to it. The demand for an examination of a company's affairs, according to the provision, would be a penal proceeding which the directors would always resist. It would be made, therefore, only when a railway came to grief, while what was needed was a government inspection when the soundness of the company was not suspected and not merely an inquiry when troubles had taken place.

Moreover, in spite of the great responsibility placed upon the Board of Trade, no principle was laid down to guide that body, as to what reasons were sufficient to justify an inquiry. Neither was there any specific rule as to the kind of evidence on which it should insist. Thus, it was apprehended that "the act might be wholly unworkable if the Board of Trade were judicial and exacting, and looked too narrowly into *prima facie* cases."[41]

It was, however, conceded that the provision for the appointment of government inspectors would generally be of some use in that the possibility of a searching inquiry would have much indirect influence over directors.[42]

In spite of its defects, however, the system of government audit and inspection was recognized to be a forward movement in the regulation of railway finance. The holders of the securities of the companies were at least afforded a chance to get government auditors and inspectors to act with their own, thus bringing pressure to bear upon the directors. All good compan-

[38] *Ibid.*
[39] *Economist*, August 29, 1868, p. 992.
[40] *Ibid.*, March 21, 1868.
[41] *Ibid.*, August 29, 1868, p. 992.
[42] *Economist*, March 21, 1868.

ies would gain by taking advantage of the provisions of the act; and the "fashion" being once established might compel companies to follow the example. The discredit arising from shutting out the light might be even worse than the discredit of the unwelcome truth itself. Although the system of government audit and inspection has been resorted to only occasionally, it appears to have proven beneficial. Parliament has not only retained the system of impartial audit, but has given it special emphasis.[43] Indeed, as said a member of the New York Bureau of Economic Research in 1901 before the United States Industrial Commission,[44] the English auditors are independent and form "almost a fourth body — a fourth cog in the wheel of government." The fact that the government has the power to appoint its own auditors to audit the accounts and to appoint inspectors to examine the affairs of the companies seemed to have considerable influence in preventing railway companies from many irregularities. Thus it appears that the mere reservation by the government of certain important privileges may often prove quite effective in checking misconducts, even if such privileges are seldom made use of.

It may be added that as years progressed, things became more settled to normal or "standard" conditions. While the accounts of some companies do not give as much as is desirable, they are generally known to be true and straightforward, and seldom make any attempt at dishonest concealment of vital points. The general practice is that they are audited half-yearly. Besides appointing professional auditors on behalf of the shareholders, many companies have an audit committee appointed for the latter body, which meets regularly for the purpose of supervising the accounts. Perhaps these measures taken by the companies may to a certain extent explain why the privilege given by the government for appointing government auditors has not been taken advantage of by the shareholders.

[43] In the "saving" clause of the Coventry Railway Bill, 1910, as to general Railway Act, the only two topics which received special emphasis were the impartial audit of accounts and the revision of the maximum rates. See sec. 43, p. 17 of the Coventry Railway Bill, 1910.

[44] *Report of the United States Industrial Commission*, 1901, Vol. IX, p. 93.

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INDEX